McKie & Co

RUDGE REVENUE REVIEW

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IS TAX AVOIDANCE WRONG?

Tax avoidance is news and, it seems, almost universally condemned. A recent article in The Church Times by Niall Cooper of *Church Action on Poverty* was accompanied by a cartoon suggesting that being morally bankrupt is a qualification for being a successful tax planner. Peter Oborne writing in the Telegraph recently said:-

> "There are few more worthless specimens of humanity than tax accountants and tax lawyers."

I must be doubly worthless, being both.

Nonetheless, I shall make the case that tax avoidance is not a major threat to Government revenues, is not immoral, is in fact the sign of a morally healthy tax system and that the current debate, based on ignorance and sloppy thinking, could result in real economic and moral damage to this country.

First, the estimates used in the debate are dubious. Christian Aid has estimated that the developing world has lost $160 billion in revenue due to tax avoidance. In a letter to the Church Times last year, a Mr Dryden pointed out that this figure is based on false data and that the actual figure is a statistically insignificant 1/40th of Christian Aid's figure (CT 28th April 2011). The TUC estimates the tax 'lost' to the UK through tax avoidance as £25 billion pa. HMRC, however, who are unlikely to want to underestimate the figure, put it at £5 billion. £5 billion is a large amount of money absolutely but it is less than 1% of the Government's annual tax receipts and less than 0.5% of the national debt. What is more, recent changes to the rules requiring advance disclosure of tax planning schemes are likely to reduce this amount still further. If it were possible to squeeze all tax avoidance out of the system it would still make little difference to funding our excess expenditure or reducing our national debt.

Even so, that does not make tax avoidance morally acceptable. To understand why it is, we need to understand the nature of our tax system.

The complexity of the modern economic system demands a complex tax system, which is made more complex by the machinations of politicians and special interest groups. My edition of operative central Government tax legislation has 18,591 pages. No single person can be familiar with it all or understand how it all interacts – least of all the MPs who vote it into law.

The result is a system which no rational person would design if he were to start with a clean sheet. Let's look at marginal rates of Income Tax; that is, how much extra tax is paid on an additional £1 of income. In 2012/13 most taxpayers who earn an additional £1 on an income of £50,000 will bear an effective rate of tax at 40%. But if they receive Child Benefit they will pay tax at 50%. £1 earned above £60,000 will bear tax at 40% again, but above £100,000 it will bear 60% tax which will reduce again to 40% on earnings above £116,210.

Taking National Insurance contributions into account, an additional £1 of earnings on an income of £30,000 will bear tax at 45%. When the taxpayer moves into the higher rate Income Tax band at £42,475 his extra £1 will be taxed at 65.8%. An extra £1 over £42,484, though, will bear tax at 55.8%. Equivalent figures for a self employed man would be 29%, 40% and 40% respectively. Taking account of the combined effect of Income Tax, National Insurance and Tax Credits, persons entering the labour market suffer marginal rates of well over 90%.

It is not just the pattern of tax rates, however, that is irrational. In many areas, the amount on which tax is charged bears little relationship to economic reality. The special rules for gains on insurance policies, for example, treat a capital gain as revenue profit and will often result in a person who makes an economic loss being taxed as if he had made an income profit and vice versa.

In such a complex system, it is inevitable that the Government's legislation will have unintended consequences. When the Labour Government decided to stimulate the small business sector by reducing the rate of Corporation Tax to nil for the smallest companies without making a corresponding reduction for unincorporated businesses, many such businesses were incorporated. The Government then reversed the reduction on the grounds that such behaviour was "tax avoidance", leaving small businesses stuck with companies they did not want and saddled with their additional costs.

HMRC collect tax in accordance with the law however bizarre or unjust the results. They won a recent case for example in which a taxpayer *paying* rent to a trust was deemed, by the relevant tax law, to have *received* that rent himself and to be taxable on it.

Under such an artificial system what principle of morality forbids one from taking steps, in accordance with the law, to avoid or reduce one's tax bill?

We all accept that the Government must spend money and must raise taxes to do so but there is no consensus on how much should be spent, how it should be spent, how much tax should be raised or from whom. The nearest we have to that consensus is the complex and highly imperfect process by which Parliament makes tax law. A country in which the citizens only pay the tax which they think is morally correct would be bankrupt. Maintaining public life is only possible if the vast majority of the Queen's subjects recognise their duty to pay the tax which the law demands whether or not they regard our tax system as irrational and unfair; as indeed, as we have seen, it is.

Let us be clear, this is not to say that a rich man has no duty to contribute to the public good. What he does not have a duty to do is to structure his transactions so as to maximise the slice of his wealth which is appropriated to be spent at the Government's discretion. Having fulfilled our duty to obey the law, we must consider our duty to contribute to the good of others in the most effective way possible. Many are deeply sceptical of the efficacy of Government spending. We might reflect, in the context of the current discussion on relief for charitable gifts, on the fact that a man with a large income who chooses to give, say, £1,000,000 to a charity decides that he would prefer to trust the charity to spend that £1,000,000 of his wealth for the good of others than for the Government to spend £500,000 of it. That does not seem to me an irrational preference. I would go further. It is clear that much Government spending is positively harmful and that it is usually better, as Gladstone said, for money "to fructify in the pockets of the people."

The very term 'tax avoidance' contains a conceptual confusion. It is an ancient and fundamental principle of our freedom under the law, that the Government has no right to tax which has not been conferred by the Queen in Parliament. The term "tax avoidance" is simply a convenient but imprecise shorthand. No right to tax arises until a state of affairs exists on which Parliament imposes tax. If the subject so arranges his affairs that a tax liability does not arise in respect of them he has not avoided tax, he has avoided entering into transactions which would have resulted in the tax liability. This is not quibbling. Underlying the condemnation of tax avoidance is an assumption that the fundamental ownership of wealth should lie, not with the individual, but with the all-powerful state.

But surely, one might object, we can distinguish acceptable tax planning from unacceptable tax avoidance and tax the latter under the law. Many attempts have been made to formulate just such a "general anti-avoidance rule". All have failed. The last Labour Government consulted on the issue in 1998 and concluded, like all previous Governments, that such a rule could not be made without creating such uncertainty in the tax system that the damage to our economy would outweigh any additional tax raised.

This Government, however, now intends to introduce just such a rule. The basic test is to be whether a taxpayer's transactions "can reasonably be regarded as a reasonable exercise of choices of conduct afforded by the Tax Acts". Such a subjective rule will make it impossible for individuals and businesses to predict the tax effects of their transactions with the result that, as the Society of Trust & Estates Practitioners has said, it will "inhibit and depress the UK economy". The Government will ignore the experience of years to appease the public clamour to be tough on tax avoidance. In this, and in many other ways, the debate threatens very substantial damage to our economy undermining, in the longer term, the economic activity on which tax is levied and which pays for public services.

There is another danger. No Government department can resist the temptation to extend its power. The febrile debate on tax avoidance provides an excuse for HMRC to do so. In recent years there has been a very significant extension of its powers to obtain information and documents and to access taxpayers' premises, including their homes and a significant increase in the amount of legislation designed with deliberate imprecision so as to give HMRC, in effect, a discretionary power to tax.

Britain has had, until quite recently, a very healthy tax system in which the vast majority of taxpayers have made honest returns and the revenue departments have conformed to basic ethical standards. Paradoxically, tax avoidance is the sign of a healthy tax system because it involves working within an accepted system of law and complying with its demands. In many other countries, in the Mediterranean, in Africa, in South America and elsewhere, corrupt officials and illegal tax evasion are rife.

Where the tax authorities exercise arbitrary discretionary power, legal tax avoidance may be squeezed out but it is replaced by widespread tax evasion. If we don't have a more informed debate about our tax system, there is a real danger that we shall create a system in which concealment and lying are an accepted part of civil behaviour. Nothing is more likely to corrupt our public life.

SETTLED EXCLUDED PROPERTY

FINANCE BILL 2012 CLAUSE 208

At the time of the Budget, the Government announced that, with effect from Budget Day, a measure would be introduced to close certain Inheritance Tax planning strategies and explained:-

> "The aim of the measure is to close avoidance schemes involving the acquisition of interests in settled property in offshore trusts by ensuring that any reduction in the value of a person's estate as a result of the arrangements is charged to IHT. The measure supports the Government's anti-avoidance strategy and fairness agenda."

Clause 208 of the Finance Bill contains the relevant provisions. At the same time as the Finance Bill, Explanatory Notes, the primary function of which is to explain to MPs the purpose and effect of the Bill, were published. The notes on Clause 208 explained that:-

> "1. Clause 208 amends the inheritance tax (IHT) settled property provisions relating to excluded property. Where an individual, domiciled in the UK, acquires an interest in settled excluded property which, as a result of arrangements concerned with that acquisition, gives rise to a reduction in the value of that individual's estate, the property will cease to be excluded property and a charge to IHT will arise. The charge will largely replicate the tax treatment that a UK-domiciled individual would incur if the assets within the offshore trust, which are 'excluded property' and which would otherwise be ignored for IHT purposes, had instead been transferred to a UK trust…
>
> If a UK-domiciled individual settles assets into an offshore trust, the transfer into trust will be charged to IHT and the value of the trust assets above the nil-rate band will also be subject to IHT.
>
> 12. But if the settlor is not UK-domiciled, settled property situated outside the UK is excluded from the IHT charge and is referred to as excluded property. Anti-avoidance provisions ensure that where an 'interest in possession' (IIP) in such excluded property is purchased for value, the trust assets are subject to IHT as part of the purchaser's estate. However, if a UK domiciled individual acquires an interest in excluded property which is not an IIP, there may be no charge to IHT when the interest is acquired and the settled property may escape any subsequent charge to IHT either as part of the individual's estate or under the relevant property regime. In addition, the individual's estate may be reduced by any debt where the acquisition is financed by a loan.
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> 13. The amendments to the settled property provisions relating to excluded property will apply to avoidance schemes where arrangements exploit the excluded property rules by converting UK assets to ones that are excluded from the IHT charge and do not give rise to a transfer of value when that conversion

occurs. In future, a transfer of value will arise and the assets will no longer be treated as excluded property and will fall within the relevant property regime."

One might have thought, from this description that the charge would apply where, for example, a person contracts with a person holding a suitable power, to exercise the power so as to add the purchaser and those whom he wishes to benefit to the class of beneficiaries and to exclude all others. Such a transaction, however, would result in the purchaser making an immediately chargeable transfer and so there is no need for further legislation in respect of it.

I spoke to the HMRC spokesman on the new clause, who was very helpful and explained that it was actually aimed at a rather specialist avoidance technique of which they had become aware otherwise than through DOTAS. From his explanation, I have constructed Example I to show the sort of transaction at which Clause 208 is aimed. That example, and the analysis which follows, is not based on any actual transactions and should not be taken as commenting on the likely success or otherwise of any actual arrangements.

EXAMPLE I – TESTING THE PROVISIONS AGAINST THEIR TARGET

HML Establishes Suitable Settlements

Harry Masters Limited ("HML"), a company resident and incorporated in a tax haven which carries on a business of acting as trustee, declared that it held ten sums of £100 each under ten separate settlements. It did so in order to be able to market a tax planning strategy involving transactions of the type undertaken by Mr Marigold (see below). Under each settlement, the terms on which the trust fund was to be held were as follows.

The Principal Interest

For a period (the "Discretionary Period") of one hundred and fifty years the Trustee was to hold the trust fund on trust either to accumulate the trust income or to pay it to a named person (the "Principal Beneficiary"). The Principal Beneficiary named in each trust deed was HML itself. The interest of a Principal Beneficiary at any time was referred to as the "Principal Interest". A Principal Interest was assignable and did not come to an end on the death of the Principal Beneficiary with the result that it could pass with the Principal Beneficiary's estate.

The Reversionary Interest

At the expiry of the Discretionary Period, the capital of the fund (including accumulations) was to pass to Kingston Black Limited ("KBL"), a subsidiary of HML absolutely (the Reversionary Interest"). The holder of the Reversionary Interest at any time was referred as the "Reversionary Beneficiary". The Trustee had the power to substitute any other person as a Reversionary Beneficiary in place of the existing one. This power could be exercised revocably or irrevocably. Once an exercise of the power became irrevocable the power could not be exercised again.

Mr Marigold Enters into the Arrangements

Paignton Marigold was a widower with children and grandchildren who was resident and domiciled in the United Kingdom and who had a substantial estate.

Preliminary Negotiations

He entered into negotiations with HML and KBL in respect of a tax planning proposal (the "Arrangements").

The Addition to the Tremlett Settlement

When Mr Marigold had decided in principle that he would proceed with the proposal but before he entered into a contract, KBL added £999,900 to one of the settlements (the "Tremlett Settlement").

Mr Marigold is made the Reversionary Beneficiary

The Trustee then exercised its power to substitute Mr Marigold as the Reversionary Beneficiary in substitution for KBL. The exercise was revocable at first but was to become irrevocable after twenty one days.

The Grant of the Call Option

Within twenty one days of this exercise of the power of substitution by the Trustee, Mr Marigold purchased an option (the "Call Option") for £1,099,900 (the "Grant Price"). Under the option Mr Marigold could require HML, by notice at any time within twenty one years, to assign to him the Principal Interest for a price of £100 (the "Exercise Price"). Under the Call Option, the Trustee warranted that it would pay to Mr Marigold an amount equal to any amount of income or capital advanced to a beneficiary before the option was exercised.

Mr Marigold settles the Reversionary Interest

Mr Marigold then settled the Reversionary Interest on broad discretionary trusts for a discretionary class consisting of his issue and any spouses of his issue.

Mr Marigold Exercises the Option

Mr Marigold subsequently exercised the Option when the value of the trust fund was £1,000,000 and paid the Grant Price of £100 to HML.

Mr Marigold's Death

On his death Mr Marigold left his interest as a beneficial object of the trust under his Will, to his children in equal shares.

The Situs of the Trust Assets

The assets of the Tremlett Settlement were at all times situated outside the UK.

The Tax Consequences of the Arrangements Ignoring Clause 208

Ignoring the effects of Clause 208, it appears that the Arrangements were intended to have the following Inheritance Tax consequences:-

The Purchase of the Call Option

In determining whether and to what extent there was a transfer of value one must value Mr Marigold's estate before and after the purchase of the Call Option.[1] Before the purchase, his estate included the money he was about to pay for the Option and the Reversionary Interest. Although a Reversionary Interest is excluded property[2] it is only immediately before his death that a person's estate is deemed not to include excluded property.[3] The market value of the Reversionary Interest on its own, however, would have been insubstantial because a purchaser would have taken into account the probability that the Trustee would use its power to advance the trust assets to itself.

After the purchase, Mr Marigold's estate included the Call Option and the Reversionary Interest. Together they gave Mr Marigold the power to obtain the trust fund which was £1,000,000. The market value of these two assets together would not have been equal to the trust fund because a purchaser would take into account the risk and inconvenience attached to enforcing the contractual and equitable duties of HML. For the sake of illustration we shall value them at £900,000. So Mr Marigold's estate decreased by £200,000 ((£1,100,000 + nil) – (£900,000)). That was not prevented from being a transfer of value by section 10 because it is clear that it was part of a series of transactions intended to confer a gratuitous benefit on Mr Marigold's issue. Because the transfer was not a gift to an individual and was not attributable to property which became comprised in the estate of an individual it was immediately chargeable.[4] So Mr Marigold made an immediately chargeable transfer of £200,000.

Mr Marigold settles the Reversionary Interest

Because the Reversionary Interest was excluded property, no account was taken of it in determining whether the settlement was a transfer of value.[5] Therefore Mr Marigold's estate was treated as not having been reduced by the settlement and there was no chargeable transfer.[6] For the same reason, neither Decennial[7] nor Exit[8] charges arose in respect of the Reversionary Interest.

Mr Marigold exercises the Call Option

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1 Section 3. All statutory references are to the Inheritance Tax Act 1984 unless otherwise stated
2 Section 48
3 Section 5(1)(b)
4 Section 3A
5 Section 3(2)
6 Section 3(1)
7 Section 64
8 Section 65

The Call Option gave Mr Marigold the ability to obtain the Principal Interest. On its exercise, he held that interest having paid a further £100. Any diminution in his estate, therefore, is likely to have been minimal.

Mr Marigold's Death

Immediately before his death, Mr Marigold held the Principal Interest. That was property[9] forming part of his estate[10] immediately before his death by reference to which IHT was to be calculated.[11] Its value was small because any purchaser would take account of the possibility that the Trustee would simply accumulate the trust income so that trust income and capital would be eventually paid to the Reversionary Beneficiary. Nevertheless it would have some value because of the prospect of negotiating with the Reversionary Beneficiary to allow the settlement to be brought to an earlier end.

If the settlement had included the power for the Trustee to shorten the trust period, the prospect of such a negotiation would probably have been slight and the value of the Principal Interest would have been insubstantial. The difficulty with such a course would have been that, between purchasing the Call Option and the expiry of the 21 day period, Mr Marigold was subject to the risk that the Trustee would revoke the substitution so that it could receive the trust fund in one hundred and fifty years time when the Reversionary Interest falls in. If the Trustee could have shortened the trust period it would be possible for it to receive the trust fund on the falling in of the reversion in a much shorter period. Such a risk is unlikely to have been acceptable to Mr Marigold.

Are the Arrangements likely to be attractive to Clients?

So it is true that, if the Arrangements are successful they will offer the ability to take a substantial amount of value out of a UK domiciled taxpayer's estate and allow him and his family to benefit from an excluded property settlement but only at the price of making a fairly substantial immediately chargeable transfer, of bearing substantial costs, of accepting some commercial risk and of accepting the possibility of a long and expensive dispute with HMRC. Although it appears that arrangements of this sort may already have been implemented by some taxpayers, even if the Arrangements were foolproof, one doubts whether there would be many taxpayers wishing to implement them in the future.

Areas of Uncertainty

Actually, the Arrangements appear to me to present a number of areas of concern.

First, if the Trustee's powers are fiduciary in nature their exercise with the purpose of earning a profit for HML could well constitute a fraud on the power.

Secondly, the fact that the bulk of the trust funds are not added until Mr Marigold is about to enter into the Arrangements and that the assignment of the Reversionary

[9] Section 272
[10] Section 5
[11] Section 4

Interest is clearly designed so that it may be reversed if he does not purchase the Call Option suggests that he might be said to be a person who made the settlement indirectly because he provided funds indirectly for the purposes of the settlement. The result would be that he would be a settlor of the settlement[12] and the settlement would not be an excluded property settlement at all.

Thirdly, if Mr Marigold had appeared likely to fail to purchase the Call Option it is clear that either the substitution of Mr Marigold as the Reversionary Beneficiary would have been revoked or the Trustee would have used its discretion to advance the trust assets to itself. In the event, because of that it might be argued that the reality of the transaction is that Mr Marigold's payment is in part made in consideration of the Trustee refraining from revoking the substitution[13] and thus represents consideration for the Reversionary Interest. If that is so the Reversionary Interest will not be excluded property in Mr Marigold's hands[14] and there will be a substantial chargeable transfer when Mr Marigold settles it.

Rather more difficult to evaluate is the fact that the Courts are currently extremely hostile to such artificial planning and generally strive very hard to frustrate it.

How the New Provisions Apply to the Contract

How would the new provisions apply to Mr Marigold's arrangements?

Clause 208 of the Finance Bill amends IHTA 1984 s.48 and also inserts two new sections into that Act, ss.74A and 74B.

The additions to s. 48 ensure that certain settled property which would otherwise be excluded property is not to be so. Sections 74A and 74B impose a special charge on an individual or on the trustees of an interest in possession trust which holds property to which an individual is treated as beneficially entitled under s.49(1).

New Section 48(3D) – (3F)

Turning first to the amendments to s.48, new sub-section 3D provides:-

> "(3D) Where –
>
> (a) one or more persons enter into arrangements,
> (b) in the course of the arrangements, an individual domiciled in the United Kingdom acquires, or becomes able to acquire, (directly or indirectly) an interest in property comprised in a settlement (the relevant settled property.),
> (c) ignoring this subsection, the relevant settled property would be excluded property by virtue of subsection (3)(a), and
> (d) there is a relevant reduction in the value of the individual's estate,

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12 Section 44
13 Section 48
14 Section 48

from the time paragraphs (a) to (d) are first satisfied, the relevant settled property is not excluded property by virtue of subsection (3)(a)."

So if these conditions are satisfied, the property in the Tremlett Settlement will not be excluded property. The result would be that Decennial Charges under s.64 and Exit Charges under s.65 would apply to the property over the settlement's life as they would do had Mr Marigold made the settlement himself.

So are the conditions of the new sub-section 3D satisfied in respect of Mr Marigold's acquisition? Plainly there are one or more persons who enter into arrangements in the course of which Mr Marigold, who is domiciled in the United Kingdom, acquires an interest in property comprised in the settlement. So Conditions (a) and (b) are satisfied.

As an aside, one might notice the use of the word "able" rather than "entitled" in (3D)(b). Anybody is able to acquire an interest in settled property in the sense of having the legal capacity to contract. One presumes that the Courts will restrict the width of this word in some way but how it will be restricted is unpredictable. It is clear, that whatever it means it has a wider meaning than 'entitled'.

The settled property meets the condition in (3D)(c) because, were it not for the new provisions and subject to the possibility that Mr Marigold is a settlor of the property, it would clearly be excluded property by virtue of s.48(3)(a) because it is non-UK situs property comprised in a settlement settled by a non-domiciled settlor.

The only remaining question, therefore, is whether there is a relevant reduction in the value of Mr Marigold's estate. There is a relevant reduction "if and when the value of the individual's estate becomes less than it would have been in the absence of the arrangements …"

As we have seen Mr Marigold's estate is reduced by £200,000 when he purchases the Call Option. Even if that were not true, the condition is satisfied when he settles the Reversionary Interest because it is clear that after that settlement the value of Mr Marigold's estate was less than it would have been had he not implemented the Arrangements.

So new sub-section (3D) will have the effect that the property within the Settlement is fully within the charge to Inheritance Tax.

New Sections 74A and 74B

New s.74A seems designed to impose a charge equivalent to the charge which would have arisen had the individual who actually acquires an interest in settled property settled that property himself. The section applies where by virtue of s.48(3D) property comprised in a settlement ceases to be excluded property. Where it applies tax is to be charged as if the individual had made a transfer of value at the time when a relevant reduction occurs or, if later, the time when the conditions in s.48(3D) are satisfied.[15] The amount on which tax is charged will be, loosely, the

[15] New section 74A(8)

amount by which the individual's estate is reduced by each relevant reduction except that if the arrangements consist of a series of operations, the chargeable amount is reduced by the amount of any transfers of value arising under the arrangements which have occurred up to the time of the relevant reduction.[16]

As we have seen in respect of Mr Marigold, the conditions of s.48(3D) are satisfied when he purchases the Call Option so that a relevant reduction of £200,000 occurs. As this is in any event a chargeable transfer the amount on which tax is charged will be reduced to nil. As we have seen a further relevant reduction occurs when Mr Marigold settles the Reversionary Interest.[17] Having undertaken the Arrangements and settled the Reversionary Interest, Mr Marigold now holds instead the rights under the Call Option. The rights under the Call Option cannot be worth more that the value of the asset, the Principal Interest, in which they subsist. We have already seen that that interest has a small, although not necessarily a negligible, value.

Clause 208 Nullifies Mr Marigold's Advantages

So the net result is that Mr Marigold, in addition to being charged on an immediately chargeable transfer of £200,000 or purchasing the Call Option will also be chargeable under section 74A(8) when he settles the Reversionary Interest on a further transfer of £900,000 or a little less. Section 74B(1) prevents that transfer of value being a potentially exempt transfer, so it is immediately chargeable. The result is that Mr Marigold makes a chargeable transfer of the same amount as he would have done had he transferred £1,100,000 (or a little less) to a discretionary trust himself. Of course, if he survives his chargeable transfers by seven years they will only bear tax at the lifetime rates but the same would have been true had he settled the funds on discretionary trusts himself. The new provisions have achieved their aim of nullifying any advantage Mr Marigold would have obtained from the Arrangements in comparison to making a settlement himself.

Is Clause 208 Necessary?

As we have seen, the planning which is the target of Clause 208 has such disadvantages and uncertainties that it is to be doubted whether it would be used by many taxpayers even if Clause 208 is not enacted. It does not appear a sufficiently serious threat to the Exchequer to justify the introduction of such complex new legislation. Some confirmation of this view is to be found in the Tax Information and Impact Note (the "TIAN") published at the time of the Chancellor's Budget Report which reveals that in the entire period for which a budget has been made (up to 2016/2017) the measure is expected to have a negligible yield. In spite of this the TIAN claims that it "supports the Exchequer in its commitment to protect revenue". How are we to understand this claim?

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16 In fixing the amount of the individual's deemed transfer of value under a new s 74A(8) there are detailed provisions to deal with situations where the relevant reduction is wholly or partly a reduction of settled property in which the individual has an interest in possession to which s.49(1) applies. These provisions are not relevant to Mr Marigold

17 If Mr Marigold had not entered into the Arrangements at all he would not have paid £1,100,000 to HML. Can we assume for the purposes of the comparison in new section 48(3E)(b) that he would have continued to hold it? In my view one must do so for the legislation provides no mechanism for determining the further consequences of the hypothesis

The explanation of why the charge has no measurable effect on future yield may be that use of the scheme to date has been negligible so that if the new provisions prevent its use in the future, future yield compared to current yield will be unaffected. If the scheme's use has been negligible to date, however, and if, as it appears, the scheme was, in any event, both unattractive and uncertain, what evidence is there to suggest that the scheme would have been widely and successfully implemented in the future even without Clause 208?

One might say, however, that apart from some new complexity not much harm is done by the new provisions. Whether that is true depends on whether the new provision also catches situations which the Government would not wish to catch. In Example II, I test the new provisions against a situation which I presume the Government would not wish to be caught by the new provisions.

EXAMPLE II – TESTING THE PROVISIONS AGAINST A TRANSACTION WHICH IS NOT THEIR TARGET

Monsieur Michelin had always been resident outside the UK, been domiciled in France and had not had any significant connections with the UK. In 2000, he settled assets (the "Michelin Settlement") on trustees resident in Geneva on broad discretionary trusts. In 2005 the trustees exercised a power to confer on him an interest in possession. The settled property was a 60% holding in the shares of a French investment company ("Frenchco"). He held the remaining 40% absolutely for himself. In 2008, he married for the second time and his new wife was domiciled and resident in the United Kingdom. They decided to divide their time between France and England with the result that neither changed their country of domicile. On his marriage he made a gift of his shareholding in Frenchco to his wife.

In April 2012, as part of an exercise to balance the interests of his wife and of his children by his previous marriage, the Trustees of the Michelin Settlement exercised their power to exclude Monsieur Michelin from benefitting under the trust, to create discretionary trusts in the trust fund and to add his wife to the class of beneficiaries. At all relevant times a 100% holding in the company was worth £10 million and a 40% holding was worth £1million.

Are the conditions of the new s.48(3D) satisfied in respect of the reorganisation of the Michelin Settlement in Example II?

Well clearly the trust reorganisation is an arrangement into which the trustees enter. In the course of that arrangement, Madame Michelin acquires an interest in the property comprised in the Settlement. If it were not for sub-section (3D) the settled property would be excluded property. So conditions (a) – (c) of subsection (3D) are satisfied. Is there a relevant reduction in the value of Madame Michelin's estate? Clearly there is.

Monsieur Michelin became entitled to his interest in possession before 22nd March 2006 and therefore, under s.49, he was treated as beneficially entitled to an interest in the settled property for as long as his interest subsisted. Because of that the shares in the settlement were related property within s.161 in respect of Madame Michelin so that, whilst Monsieur Michelin's interest in possession existed, her 40% holding in Frenchco was valued as a proportionate part of the value of the whole company and thus was valued at £4million. Once the interest in possession had ceased, the shares in the settlement were no longer related property and therefore her shareholding was valued simply as a 40% holding at £1million. So the reduction in her estate due to the trust reorganisation was £3 million. She was deemed to make a transfer of value of that amount by virtue of s.74A(8) and that was a chargeable transfer by virtue of s.74B(1). What is more, the shares in the settlement will not be excluded property for the purposes of future Decennial and Exit charges. The Trustees' reorganisation of the trust interests has been a disaster resulting in an immediate tax charge of £1,070,000 (£3 million - £325,000 x 40%) with further charges within the trust to come.

Unintended Tax Charge

So this piece of anti-avoidance legislation which is predicted to have a negligible yield being directed at a piece of tax planning which is unlikely to be attractive to many taxpayers can certainly apply to arrangements to which it is not intended that it should apply. How difficult will be the problems it causes, only time will tell.

HOW CAN MPs JUDGE THE NECESSITY OF THIS PROVISION?

In passing tax legislation it is the duty of our Members of Parliament to consider its effects on the Exchequer's income, the balancing disadvantages of increasing complexity in the tax system and the distorting economic effects which unintended tax charges create. How could they be expected to do this when the Explanatory Notes do not give an example, even in outline, of the sort of transaction which Clause 208 is designed to frustrate?

A CONUNDRUM

In our last issue we offered a gift of a free copy of the latest edition of Tolley's Estate Planning to anyone who could solve the conundrum below.

It is generally accepted in practice that in respect of the IHT charge on death, those reliefs are given which would apply if the actual devolution of the estate on death were a chargeable transfer. For example, if a husband leaves all of his property by will to his spouse, it is accepted that the disposition which is deemed to arise on death under s.4(1) is an exempt, inter-spouse transfer under s.18.

Why is this? IHT is charged under s.4(1) "…as if immediately before …[the]…death, … [the deceased]…had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death." Now notice that this transfer of value is purely hypothetical. It is not the actual devolution of the estate which occurs under the deceased's will or intestacy and there is no statutory mechanism to impose the provisions of that will or the intestacy rules on the hypothetical transfer.

It is true that section 3(4) ensures that any provision in the Inheritance Tax Act referring to a transfer of value can refer to the occasion of a charge under s.4(1) so that these provisions are to be construed as treating the deceased as the transferor. What s.3(4) does not do, however, is attribute the provisions of the deceased's will or intestacy to the deemed transfer of value.

So why isn't IHT charged on death without the application of any of the exempt transfer provisions?

Our prize was won by David Rothenberg of Blick Rothenberg for his part in the following correspondence.

"Dear Simon

'fools rush in. where.......'.

Section 4(1) is not a charging provision at all. It is necessary to look at s.3(1). What that says is that "*subject to the following provisions of this Act* a transfer of value is a disposition made by a person ... as a result of which the value of his estate immediately after the disposition is less ..."

Section 4(1) - which of course is a 'following provision' - merely addresses the transfer of value on death where without that subsection there would be no reduction in the value of the estate; arguably a dead person cannot make a disposition.

So now s.4(1) has created a transfer of value, and s.18(1) says that this transfer of value (note not disposition) to the surviving spouse is to be exempt.

QED

David Rothenberg

Dear David

Thank you for this. Your response is interesting but I don't think it quite answers the conundrum.

As you say a dead person cannot make a disposition. Because of that, without a deeming provision, there would be no charge on death. Section 4(1) in conjunction with s.3 creates the charge by providing that tax is to be charged on the hypothesis that the deceased had made a transfer of value immediately before his death of an amount equal to the value of his estate at that time. On the basis of that hypothesis, s.1 and s.7 and many other sections combine to determine the charge.

That hypothetical transfer is not the actual devolution of the deceased's property which takes place under his Will. We are given no information about the identity of the person or persons to whom the hypothetical transfer is to be treated as having been made. As far as I can see, there is nothing to suggest that the persons to whom the property actually passes under the Will are to be deemed to be the recipients of the hypothetical transfer taking place immediately before the deceased's death. So I think the gap in your logic is that we do not have a transfer of value to the surviving spouse and therefore the conditions of s. 18 in respect of the hypothetical transfer are not met.

Although I do not think you have solved the conundrum, I think your response is very useful and certainly sufficient to win the prize. A copy of Tolley's Estate Planning will wing its way to you shortly. I thought it might be interesting to publish the correspondence in the next Issue of the Rudge Revenue Review if you were happy for us to do that. You might even like a second bite at the cherry to respond to the points I have made. I shall give you the last word.

Yours sincerely
Simon McKie

Dear Simon

My only comment would be that s.4(1) is not a charging provision, but merely a provision that says that tax shall be charged on the basis of a deemed situation.

So what happens on death?

Section 18 says that a transfer of value between spouses is exempt. Is the transfer of value referred to in s.18 the transfer hypothesized in s.4(1)? You quite rightly say that nothing in the legislation says in terms that it is. Because s18 does not tell us where the transfer of value between spouses on a death is to be found, it becomes necessary to look to s.4(1) to answer that question.

So I believe that in interspousal transfers on death it is necessary to turn to s.4(1) to fill a gap, rather than a gap being created by s.4(1).

Regards
David”