Practice guide

How to handle the reservation of benefit provisions

Speed read

Recent case law confirms that the reservation of benefit legislation is difficult to apply in practice; areas of doubt continue. Small differences in fact can result in very different outcomes. The legislation is penal in nature and taxpayers may often be worse off by making a gift with reservation than doing nothing. Particular attention is needed if a gift of land is envisaged: anti-avoidance legislation ranging from anti-*Ingram* legislation in FA 1999 to pre-owned assets tax in FA 2004 prevents people giving away their homes and continuing to live there. There are statutory reliefs, such as the full consideration and co-ownership exemptions, but the conditions need to be observed carefully. The position is always tested in the seven years prior to death so merely surviving seven years from the gift does not avoid a gift with reservation problem.

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IHT cases can be a little like buses: there are none at all for some years, and then two come along in swift succession. Two important cases clarifying the scope of the reservation of benefit (ROB) provisions were recently heard by the Court of Appeal: *Buzzoni and others v HMRC; In re the Estate of Kamhi, decd* (*Buzzoni*) [2013] EWCA Civ 1684 and *Viscount Hood (Executor of the Estate of Lady Diana Hood) v HMRC* (*Lady Hood*) [2018] EWCA Civ 2405. Both consider the ROB legislation, although the Court of Appeal reached different conclusions in each case. The case law generally illustrates the difficulty of applying the ROB provisions to practical situations.

In the home loan 'test' case of *Shelford (Executors of J Herbert) v HMRC* [2020] UKFTT 53 (TC), it was hoped that further light would be shed on the ROB provisions and, in particular, on the associated operations provisions and whether a sale to a qualifying interest in possession trust for a settlor is a gift at all. However, in the event, the judge did not consider the ROB legislation at all and found against the taxpayer on other grounds.

What are the ROB provisions attempting to do?

Under capital transfer tax, there were no anti-avoidance provisions stopping people giving away their property and continuing to benefit from it. As they were taxed at the point when they made the lifetime gift it was not necessary. On the introduction of the potentially exempt transfer (PET) concept in 1986 it became possible to make a tax-free lifetime gift and to retain the use of/benefit in the gifted property.

This led to the introduction of gift with reservation (GWR) legislation (lifted from estate duty). The objective was to stop people making gifts and still benefiting from the property, i.e. 'have your cake and eating it' arrangements.

The key provision is FA 1986 s 102(1), which is as follows:

> '(1) … this section applies where, on or after 28th March 1986, an individual disposes of any property by way of gift and either—
>
> > '(a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period; or
> >
> > '(b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor [limb 1] and of any benefit to him by contract or otherwise [limb 2];
>
> 'and in this section 'the relevant period' means a period ending on the date of the donor's death and beginning seven years before that date or, if it is later, on the date of the gift.'

The effect of a ROB

If there is any property subject to a ROB then that property is deemed for all IHT purposes as property to which the deceased donor is beneficially entitled immediately before his death (FA 1986 s 102(3)). If the reservation ends within seven years of the death, the donor is deemed to make a PET (FA 1986 s 102(4)).

The rule is intended to be penal in nature. Not only is the donor subject to IHT on death, there is no capital gains tax uplift. There is also, HMRC argues, no spouse exemption even if the reserved benefit property passes to the spouse/civil partner. The property remains part of the donee's estate so can be taxed on that donee's death. Moreover, if the gift is into a discretionary trust from which the donor can benefit, there are ten year and exit charges to pay as well as the 40% charge on death. No credit is given for one against the other.

Consider the following examples.

Example 1

Chris gives a picture worth £10,000 to his daughter Anna in 1987. Anna hangs the picture on her walls for 30 years, but then in 2017 she tells Chris he can have it back for a while and says she will just keep it on her insurance. Chris dies with the picture in his living room. It is discovered it is a long-lost Turner worth £1m at Chris's death. Tax is due on the picture at 40% (assuming Chris has no available nil rate band). Although his free estate passes to his widow and is exempt from IHT, as the property is owned by Anna there is no possibility of spouse exemption. Liability for the IHT falls on Anna first but if she fails to pay it within 12 months then on Chris' personal representatives (IHTA 1984 ss 204(9) and 200).

In order to pay the IHT, Anna sells the picture. She pays tax on the gain of £990,000. The shock kills her, and she dies leaving everything to her children. Further IHT is then payable on the picture (as quick succession relief is not relevant here).

Contrast this with the position where Chris did no planning. On his death, the picture would have passed to his wife tax free. She could then have given it away with no CGT payable and would just need to survive seven years (and avoid a ROB).

Generally, gifts between spouses are protected from ROB problems by FA 1986 s 102(5); however, gifts between cohabitees are not protected from ROB, even if they later marry.

Example 2

Harry gives his London flat to his boyfriend in 2004. In 2019, they marry and Harry continues to use the flat rent free. There is a ROB on his death that is not cured by the marriage. Harry should have retained a share in the London flat and taken advantage of FA 1986 s 102(B) discussed below.

Spouse/civil partner exemption

Transfers between spouses can cause problems under ROB where they have a different domicile. The following gifts are wholly exempt and therefore protected from ROB under FA 1986 s 102(5):

- transfers between two spouses/civil partners both domiciled or deemed domiciled here;
- transfers from the foreign dom to the UK domiciled spouse/civil partner; and
- transfers between two spouses/civil partners both of whom are foreign domiciled.

But the following gift is not protected.

Example 3

Imelda, a foreign domiciled wife is given some valuable shares by her husband Bill, a UK dom. That gift is not spouse exempt (assuming Imelda does not elect to be deemed domiciled under IHTA 1984 s 267ZA) except as to £325,000. If Imelda now settles the shares into an excluded property trust, assuming the shares are foreign situs she avoids an entry charge, but Bill must be excluded as a beneficiary and not receive any benefit otherwise there will be a ROB on his death.

Technical provisions

When working out the ROB position, it is worth going back to both the legislation and examining how the extensive case law is applied. FA 1986 s 102 is very similar to the estate duty provisions.

Section 102(1)(a) requires that possession and enjoyment of the gifted property is bona fide assumed by the donee. The main case here is *Commissioner of Stamp Duties of New South Wales v Perpetual Trustee Co Ltd* [1943] AC 425, where the donor settled shares to which he retained legal title as trustee for his son's benefit for the trustees to apply during the son's minority the whole or any part of the income or capital as the trustees thought fit for the son's maintenance and advancement. Once the son turned 21, the trustee was to transfer the capital and all accumulations of income to him. No part of the dividends or income were paid to the son during his minority. The Revenue argued that possession and enjoyment had not been assumed by the donee. The Privy Council held that the donee was the recipient of the gift (whether the son alone was the donee or the son and the body of trustees). 'The son was (through the medium of the trustees) immediately put in such bona fide beneficial possession and enjoyment of the property comprised in the gift as the nature of the gift and the circumstances permitted'. The retention of legal title by the settlor as trustee was irrelevant, and there was no ROB.

Section 102(1)(b) has two limbs:

- that the gifted property is in fact enjoyed virtually to the entire exclusion of the donor (limb 1); and
- that there is no benefit to the donor by contract or otherwise (limb 2).

Clearly, for both limbs, it is necessary to identify precisely the gifted property. As Lord Hoffmann put it in *Ingram v IRC* [1999] STC 37 (at 41): 'The theme which runs through all the cases is that although the section does not allow a donor to have his cake and eat it, there is nothing to stop him carefully dividing up the cake, eating part and having the rest.'

Both limbs require the donor's benefit or enjoyment to be referable to the gifted property not the retained property; this is the so-called 'carve out' concept (see also HMRC's *Inheritance Tax Manual* at IHTM14333). Lord Hoffmann noted in *Ingram*: 'If the benefits the donor continues to enjoy are by virtue of property which was never comprised in the gift, he has not reserved any benefit out of the property of which he disposed.'

> The ROB legislation continues to be relevant to IHT planning, and the 2017 changes to foreign domiciliaries have extended its scope and importance

Munro v Commissioners of Stamp Duty of New South Wales [1934] AC 61 is a good illustration of the referability point in relation to limb 1. The donor granted a partnership of which he was a member of an informal tenancy to farm his land. The tenancy continued in favour of the partnership after the gift, so the donor did enjoy the land as partner (even though he may have received no benefit) but it was held there was no reservation as the gift was made subject to the rights of the partnership. His occupation was referable to property not included in the gift. This carve out principle has been a theme of much new and old case law. See, for example, *St Aubyn v A-G* [1952] AC 15 in relation to gifts of shares. In the more recent cases of *Buzzoni* [2013] EWCA Civ 1684 and *Lady Hood* [2018] EWCA Civ 2405, the sub-lease gifted to the donees was subject to covenants in favour of the donor. Although in the end it was held that limb 2 not limb 1 was in point, in both cases the Court of Appeal held that the rights conferred on the donor by the covenants given by the donee were obtained by virtue of the gifted property, and not by virtue of the reversion retained by the donor. Hence the 'carve out' argument failed.

Of course, FA 1986 ss 102A–102C (inserted by FA 1999) have significantly limited the applicability of the carve out principle in relation to land, but the concept is still relevant for gifts of other assets or in relation to terminations of qualifying interests in possession in settled property (s 102ZA). (These issues are not discussed further here.)

Limb 1 has a narrower focus than limb 2. It requires that the donor is 'virtually' excluded from any enjoyment of the gifted property. With one exception the fact that the donor may receive no actual benefit (e.g. because he pays full consideration) is immaterial. As was noted in *Chick v Comms of Stamp Duties*[1958] 2 All ER 623 'if [the donor] has not been so excluded [from the subject matter of the gift] the eye can look no further to see whether his non-exclusion has been advantageous or otherwise to the donee.' Here the facts were similar to *Munro* above except that the partnership was entered into after rather than before the gift.

The one statutory exception that allows enjoyment provided there is no benefit relates to land and chattels. Actual occupation or enjoyment is disregarded if the chattel or land is enjoyed for full consideration in money or money's worth (FA 1986 Sch 20 para 6(1)(a)). However, giving cash to an individual who then lends it back to the donor charging a commercial rate of interest would, in HMRC's view, be caught by limb 1, even though there is no benefit (see IHTM14336).

For limb 2, *benefit* (not merely enjoyment) of the gifted property is required. Three points must be satisfied before a ROB arises under this limb.

First, the benefit to the donor must consist of some advantage which the donor did not enjoy before he made the gift. Millett LJ in *Ingram v IRC* [1997] STC 1234, 1268 in the Court of Appeal noted: 'From these cases, I conclude that to come within the scope of the second limb ... the benefit must consist of some advantage which the donor did not enjoy before he made the gift.' This was specifically endorsed by Moses LJ in *Buzzoni* (at para 51) and in *Lady Hood* (at para 63).

Second, the donor's benefit must be by virtue of the property he has given away. That goes to the referability concept discussed above which applies equally to limb 1 and requires identification of the gifted property.

Third, there must be detriment to the donee. (Note that this requirement is irrelevant to limb 1; all that is required under that limb is for the donor to enjoy the property.)

Until *Buzzoni*, the detriment argument was doubted by many to be valid under the IHT legislation. However, in the Court of Appeal Moses LJ noted:

> 'The second limb of section 102(1)(b) of the 1986 Act requires consideration of whether the donee's enjoyment of the property gifted is to the exclusion of any benefit to the donor. The focus is not primarily on the question whether the donor has obtained a benefit from the gifted property but whether the donee's enjoyment of that property remains exclusive. The statutory question is whether the donee enjoyed the property to the entire exclusion or virtually to the entire exclusion of any benefit to the donor. If the benefit to the donor does not have any impact on the donee's enjoyment, in my view, then the donee's enjoyment is to the entire exclusion of any benefit to the donor.'

In short, the fact that the donor enjoyed a new benefit as a result of the gift is a necessary condition of limb 2, but may not in all cases be a sufficient condition. In that case the donees had immediately before the gift already entered into covenants directly with the freeholder and therefore the presence of the covenants in the gifted property was not to their detriment – they were already bound by them. By contrast, *Lady Hood* failed because the covenants given to the donor by the donees were a new benefit conferred on her and were detrimental for the donees – they had not already entered into a sub-licence with the freeholder. Some may feel this is a distinction without a difference.

Current areas of difficulty with HMRC

For more than 30 years, HMRC has generally applied the ROB rules in a reasonable and pragmatic way. However, some areas of doubt remain.

One relates to the position where the settlor is not a beneficiary of a discretionary trust but could be added. In *Eversden (exors of Greenstock dec'd)* [2002] STC 1109, Lightman J agreed with the Special Commissioner that if the settlor was a discretionary beneficiary he was not entirely excluded from the settled property as he had a right to be considered as the potential recipient of benefit by the trustees even if the trustees do not actually benefit him. However, where the settlor is not a beneficiary but could be added, in the view of this author, arguably no ROB arises until such time as the settlor is added provided that as a matter of fact the trust fund is enjoyed to the settlor's entire exclusion, and the settlor receives no actual benefit. The trustees are under no requirement to consider the settlor who is not a beneficiary. Therefore, neither limb in s 102(1)(b) is relevant. HMRC does not accept this view; although from its example at IHTM14393 (below), it seems difficult to see how Anthony is enjoying the gifted property if he is not a beneficiary (and does not actually benefit):

> 'Anthony transfers assets into a discretionary settlement under which he is not included in the class of beneficiaries. There is however power to the trustees to add beneficiaries including Anthony to the class at some future date. That Anthony can be considered as a potential beneficiary is sufficient to say that the trust fund is not enjoyed to the entire or virtually the entire exclusion of benefit to him under the settlement and the gift will be a GWR (*CIR v Eversden*). Only if the trust irrevocably excluded Anthony from being a beneficiary under the trust will a GWR not arise.'

Another problem is HMRC's attitude to the availability of the spouse exemption on the death of the donor. This is becoming increasingly important since 6 April 2017 in two respects.

First, some settlors of trusts that were funded when foreign domiciled may die resident in the UK. If they were born here with a UK domicile of origin, then from 6 April 2017 they are subject to specific anti-avoidance provisions. IHTA 1984 ss 267(1)(aa) and 48(3E) effectively provide that a formerly domiciled resident who is UK resident for more than one tax year loses any IHT protections on trusts set up, whatever their actual domicile.

Example 4

Nick is the settlor and beneficiary of a discretionary trust set up in May 1998. He was foreign domiciled when he set up the trust. He was born in the UK and at that time his parents were married and his father was English and his mother Swiss. His parents divorced when he was two years old, and he has lived in Switzerland most of his life. He is posted to the UK on a five-year banking assignment in 2015. From 2017, the trust is not excluded property while he is UK resident. In May 2018, the trust will have to pay a ten-year anniversary charge (although at a reduced rate). Moreover, if Nick dies while UK resident the trust property would be subject to a ROB charge.

Second, similar problems arise even for foreign domiciled persons with no connection to the UK if they are the settlor and beneficiary of a trust that holds Sch A1 property (enveloped UK residential property).

What then is the position if the trust ends on the settlor's death, there is a ROB and the property passes to the spouse outright? HMRC does not consider that spouse exemption is available (see IHTM14303), but it is difficult to see the basis for this view where under the terms of the settlement the property factually becomes comprised in the spouse's estate on the settlor's death. The donor is deemed beneficially entitled to the property for all IHT purposes and on the transfer to the spouse the conditions of s 18 are satisfied as the spouse's estate is increased. The position would be different if the property was appointed by the trustees to the spouse outright in the donor's lifetime. In these circumstances, the donor is effectively excluded and a deemed PET arises under s 102(4). There is no scope then for spouse exemption to apply.

Assuming HMRC is wrong about the availability of the spouse exemption on death of the settlor who has reserved a benefit in settled property, is there a better option than the spouse becoming absolutely entitled on Nick's death which could still secure spouse exemption? Absolute entitlement by the spouse may be undesirable for CGT or non-tax reasons. The trustees could confer on Nick a testamentary general power of appointment which he then exercises by Will, settling the trust property on interest in possession trusts for the spouse on his death. In these circumstances the spouse takes an immediate post death interest under IHTA 1984 s 49A (as the property is deemed resettled by will under the power) and the settled property is deemed comprised in her estate. Spouse exemption should then be available on Nick's death, despite his ROB.

The principle of creating an immediate post-death interest (IPDI) by use of a general power of appointment was confirmed by HMRC (at answer 15 in the 2008 questions and answers with STEP/CIOT; see www.tmsnrt.rs/2xh5ml7). Note that, in our example above, it is Nick who must exercise this power by general appointment in his will, not the trustees.

Let outs and reliefs

The full consideration let out has already been referred to (FA 1986 Sch 20 para 6(1)(a)). It may be useful to consider the options if a reservation has been identified; for example, where the donor gave away a house and continues to occupy it. In these circumstances, the donor could start paying full consideration for occupation and hopefully survive seven years. The consideration must be reviewed regularly and continue to be paid until the donor's death (or until he moves out of the house).

Another relief is found in FA 1986 Sch 20 para 6(1)(b). This provides that occupation of land by the donor is disregarded if:

- the occupation results from an unforeseen change in the donor's circumstances since the gift that occurs at a time when the donor has become unable to maintain himself through old age, infirmity or otherwise; and
- it represents a reasonable provision by the donee for the care and maintenance of the donor and the donee is a relative of the donor or his spouse or civil partner.

Example 5

Mary is an elderly relative who gave away her London home many years ago to her daughter, moving into a small cottage by the seaside. Mary has now lost capacity and is unable to care for herself. Her daughter decides to bring her back to the London home where her daughter is living so that she can be cared for properly. In those circumstances the above exemption can apply.

A much used statutory relief is a sharing arrangement. FA 1986 s 102B(4) provides that there is no ROB where:

- the donor disposes by way of gift on or after 9 March 1999 of an undivided share of an interest in land;
- the donor and donee occupy the land; and
- the donor does not receive any benefit other than a negligible one, which is provided by or at the expense of the donee for some reason connected with the gift.

There is no requirement for occupation by the donor and donee as a *family* home. In theory, the donor could give any share (even 90%) away and retain 10%, although HMRC now indicates that this could be disclosable under the IHT DOTAS regulations. If A and B each own a 50% share in land and A gives his entire share to C but continues to occupy, read literally the section still applies.

Example 6

Glen, now a widower and retired academic, lives in the family home in Oxford. His married daughter lives in London and comes to stay with her two young children in holidays and some weekends. His son is based in France. Glen gives the daughter a 50% share in his Oxford house and continues to pay all the outgoings on the property. The following should be noted:

- Section 102B(4) will apply to prevent a ROB on Glen's death provided the daughter occupies the property with Glen (until Glen moves out). She must be able to come and go as she pleases; have her own key and control of the property. In effect, it is her second home. She should register for council tax and be named on the utility and insurance bills. She should have her own contents in the home, i.e. there must be substantive occupation even if not as a main home.
- The gift is a PET by Glen and he must survive seven years. His retained 50% share will have a discounted value to reflect the fact of joint ownership.
- On a sale of the property, the proceeds should be split equally.
- There is no pre-owned assets income tax charge, as there is a specific let out (FA 2004 Sch 15 para 11(5)(c)).
- The daughter will not obtain principal private residence relief on the Oxford property, unless she elects under TCGA 1992 s 222(5).
- The daughter should not pay all the expenses. This could be regarded as conferring a collateral benefit on the donor. The safest option may be for Glen to go on paying all the bills and at least more of the utility bills than his daughter, given that he is spending more time there than her.
- If the daughter dies or ceases to occupy, Glen must either move out or pay rent. There may be IHT payable on the daughter's death. What is required is occupation by *the donee*. Occupation by the spouse of the donee after her death will not suffice.

Assume that Glen dies within seven years of the gift to his daughter leaving his remaining estate (comprising mostly his share in the Oxford house) to his son. The gift to his daughter uses up his nil rate band, with the result that the son pays tax on the entirety of his inheritance. This can result in unfairness between siblings.

Conclusion

The ROB legislation continues to be relevant to IHT planning, and the 2017 changes to foreign domiciliaries have extended its scope and importance. It prevents planning of the sort that many 'mid wealthy' people often want to do, namely give away their home and continue to live there. This article does not discuss the more complicated interactions with the pre-owned asset tax (POAT) and excluded property, but practitioners should be aware of the potentially wide-ranging and penal nature of these provisions. ■