

## **TAX PLANNING BULLETIN**

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### **Introduction**

Inheritance Tax is in the news. David Blunkett wants to extend it, Steven Byers wants to abolish it, as does the Conservatives' Tax Reform Commission whilst nobody knows what George Osborn the Shadow Chancellor wants: except that it is whatever David Cameron tells him it is.

Meanwhile, Mr Brown has converted it into Capital Transfer Tax without telling anyone about it; a Capital Transfer Tax with teeth. The tax already yields two and a quarter times as much as it did when Mr Brown became Chancellor and its yield will rise as this year's 'reforms' begin to bite.

The tax remains eminently mitigatable. Taxpayers who don't want their own widows and orphans to be robbed by the Chancellor need to review their financial affairs now. The last minute changes to the Finance Act conceded by the Government may have persuaded many that they do not need to take advice. That is far from being the case. Virtually every trust and every Will in respect of an estate over the nil rate band requires, at least, a reconsideration. We, as always, will be happy to help.

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## **A. CAPITAL GAINS TAX**

### **1. Settlor-Interested Trusts and Settlements: New Rules from 2006/07**

#### **Context**

The definitions of 'settlor-interested' for CGT purposes in TCGA 1992 s77 and s169F have been extended: from 6 April 2006 a settlor is regarded as having an interest in a settlement if any of the settled property, or derived property, is, will or may become payable to, or applied for the benefit of, a dependent child of the settlor. A dependent child is a minor child, including a stepchild, who is neither married nor in a civil partnership. There has been no change to the tax treatment of bare trusts the gains of which will continue to be chargeable on the beneficiary.

***A provision prevents the extended definition applying in a case where special CGT treatment would apply to a vulnerable beneficiary.***

So the fact that a parent of a vulnerable person, who as a settlor of the settlement, is now treated as having an interest in the settlement solely because of the amendment of s77, is disregarded. A gain where special CGT treatment would otherwise be available will not be chargeable on the settlor and the special tax treatment will still apply. But if the settlor is treated as having an interest in the settlement for any other reason then, just as before, the special tax treatment will not be available.

*(HMRC Tax Bulletin 84 August 2006 p5)*

#### **Comment**

In what circumstances could this relieving provision apply? With a vulnerable beneficiary election for a bereaved minor where the Will trust was made by the deceased parent, there will be no-one on whom the s77 gains could be assessed! But presumably it could apply either to a trust made for a disabled person or to the case where the bereaved minor trust arises in other circumstances, for example, under a Criminal Injuries Compensation Scheme claim.

What happens where, as a result of the extension of the definition of 'settlor-interested', a settlement which had brought forward losses from 2005/06 makes gains in 2006/07 to be taxed on the settlor? It seems from s77(1)(b) applying s2(2) that the losses **can** be offset against current year trust gains before assessment of any net balance on the settlor.

### **2. Settlements Legislation: New Definition of 'Settlor'**

FA 2006 Schs 12 and 13 have changed the definition of a 'settlor' for CGT and income tax purposes so as to include the word 'undertaken' (a person who has undertaken to provide property). It is unclear what this word will mean – eg, does it include a guarantor?

### 3. Trusts Modernisation: Sub-fund Elections

#### **Context**

Once a valid election is in place the sub-fund is treated as a separate settlement for all tax purposes, with the exception of the annual exempt amount for CGT. The sub-fund does not have its own annual exemption.

#### ***So what is the sub-funds exemption?***

The amount that would have been available to the principal settlement had there been no election is divided equally between the principal settlement and its sub-funds, insofar as they are not excluded settlements (TCGA 1992 Sch 1 para 2(7)).

*(HMRC Tax Bulletin 84 August 2006 p4)*

#### **Comment**

Note that this is the one case where the annual exemption for a settlement for 2006/07 could be less than £880 (1/10<sup>th</sup> of the individual's annual exemption).

#### ***The Standard Rate Band: Anti-Fragmentation Income Rule***

TA 1988 s686D introduced a standard rate band, whereby the first £500 of income which would otherwise be chargeable at the special trust rates is instead chargeable at the basic (22%), savings (20%) or dividend ordinary (10%) rates, depending on the nature of the income. The standard rate band has been raised to £1,000 for 2006/2007.

A new TA 1988 s686E further modifies the standard rate band where a settlor has made more than one settlement. Where this is the case, the standard rate band for each such settlement is reduced by dividing £1,000 by the total number of settlements, though it cannot be reduced to less than £200. Any settlement which is in existence during any part of the tax year counts towards the total number of the settlor's settlements. If there is more than one settlor, the amount is reduced by reference to the settlor with the highest number of settlements. Where a sub-fund election has been made, the sub-fund is treated as a separate settlement and so must be included in the total number of the settlor's settlements.

The Trust and Estate Return for 2006/07 and later years will be amended to include a new Question 9A to enable trustees to state the amount of standard rate band to which they are entitled.

*(HMRC Tax Bulletin 84 August 2006 p5)*

#### **Comment**

We include the above by way of interest, while on the subject of anti-fragmentation, though one can hardly imagine people creating multiple small income trusts to take advantage of the exemption – considering the professional costs involved in working out the sums!

#### 4. **Expiry of Code of Practice 10 Facility in Respect of the Substantial Shareholdings Exemption (TCGA 1992 Sch 7AC) and Introduction of a Revised Facility for Taper Relief (TCGA 1992 Sch A1)**

##### ***Context***

HMRC Tax Bulletin 62, issued in December 2002, detailed what to do if a taxpayer wanted to know if a company was a trading company or the holding company of a trading group or subgroup for the purposes of both the Substantial Shareholdings Exemption and Taper Relief. The relevant definition was enacted in FA 2002.

In May 2002 the Economic Secretary to the Treasury announced that, where there was genuine uncertainty, a company could seek an opinion from HMRC under Code of Practice 10 (Information and Advice) as to its trading status. **COP 10 says that if there is uncertainty about HMRC's interpretation of the law (including its application to a proposed transaction), HMRC would advise upon the interpretation of legislation passed in the last four Finance Acts. That period (extended slightly because two Finance Acts were enacted in 2005) has now passed following Royal Assent to Finance Act 2006. Consequently from that date the facility is no longer available.**

##### ***Substantial Shareholdings Exemption (Sch 7AC)***

For the purposes of the Substantial Shareholdings Exemption a shareholder may want to establish whether a company in which shares (or interest in shares or assets related to shares) were held and which it has now disposed of, was a qualifying company. In the first instance, the shareholder should seek advice from that company. The company will usually be able to confirm if its activities were such that it was a trading company, the holding company of a trading group or trading sub-group within the meaning of the legislation.

The responsibility for ascertaining the status of any company referred to in the Self Assessment Corporation Tax return rests with the shareholding company. That company will need to take a view in conjunction with published guidance (currently in HMRC Tax Bulletin 62) and make the return on that basis in accordance with ordinary self assessment principles.

##### ***Taper Relief (Schedule A1 TCGA 1992)***

For Taper Relief if a shareholder wants to establish whether a company in which shares were held which he has now disposed of was a qualifying company, in the first instance he should seek advice from that company. The company will usually be able to tell him if its activities were such that it was a trading company, or the holding company of a trading group, so that it could have been a qualifying company so far as the shareholder was concerned.

The responsibility for ascertaining the status of a company referred to in the Self Assessment Income Tax return rests with the taxpayer. Consequently he will need to take a view and make the return on that basis. (Where appropriate he may wish to point out in the white space on the return that he has made an unsuccessful approach to the company for confirmation of its status.)

However, HMRC appreciate that in some circumstances a significant number of shareholders may need to know the status of a company after making disposals of shares AND the company itself has genuine doubt as to its trading status. In such circumstances, **the company may**

**seek a post-transaction ruling from its HMRC Officer for the assistance of the individual shareholders.** Any request should be in the format prescribed in appendix 1 of COP 10. **The Officer dealing with the company's tax affairs will not be able to correspond directly with individual shareholders for reasons of confidentiality.**

Any opinion that a company is or is not a trading company, or a group is or is not a trading group, can relate only to the period for which information has been made available. It is possible for a company or group to change its status at any time, as its business or activities change. HMRC Officers will only be able to give a firm opinion on the status of a company for periods that have ended where all the relevant facts are available.

*(HMRC Tax Bulletin 84 August 2006 p6)*

**Comment**

Under the former regime HMRC would accept an application for a pre-transaction ruling (see Tax Bulletin December 2002). The removal of the facility for pre-transaction rulings applies from 19 July 2006.

## B. INHERITANCE TAX

### 5. Business Property Relief: Was the Making of Loans 'Making or Holding Investments'?

#### **Context**

IHTA 1984 s105(3) excludes from the definition of '*relevant business property*': '*a business or interest in a business, or shares in or securities of a company, ... if the business or, as the case may be, the business carried on by the company consists wholly or mainly of one or more of the following, that is to say, dealing in securities, stocks or shares, land or buildings or making or holding investments.*'

#### ***Phillips and others (executors of Phillips deceased) v HMRC: the facts***

Mr Phillips owned shares in 8 related family companies, including P Ltd and an estate agency company, which he had established or acquired and which had shareholders and/or directors in common. P Ltd was established in 1958 and its principal object, set out in its articles of association, was to acquire land and buildings for the purposes of investment only and with a view to receiving income. By April 1989 P Ltd held at least 18 investment properties. However, the estate agency company was struggling financially and accordingly in July 1989 Mr Phillips sold 14 of those investment properties to the estate agency company for £450,000, which was raised by a £300,000 loan from the bank, which had a first charge on the properties, and a £150,000 loan from P Ltd.

At the time of the transfer the properties were let to protected tenants and so the values were not open market values for unencumbered properties. The arrangement was that, as and when each property became available with vacant possession, the estate agency company would sell the property on the open market and repay first the bank loan and then P Ltd's loan. At the same time Mr Phillips decided that P Ltd would not invest in any other property but would only make loans to other related companies. Those loans financed the purchase by the related companies of investment properties, were repayable at will and were very informal in character. P Ltd did not acquire any formal charge over any property or take a floating charge over the property of the borrowing company and it always charged them interest at 2.5% above base rate.

In March 2000 Mr Phillips died and all the shares he owned passed to his widow, who died in June 2001. On the widow's death her property, including 245,000 £1 ordinary shares in P Ltd, passed to the appellants, her children, as the executors of her Will. At the time of her death, 11 loans were outstanding from four related family companies.

The appellants argued that the shares in P Ltd were relevant business property, and thus entitled to 100% BPR under IHTA 1984 s104. S104 provides that, where the whole or part of the value transferred is attributable to the value of any relevant business property, the whole or that part of the value transferred shall be treated as reduced by, in the present appeal, 100%.

In October 2005 HMRC issued a notice of determination that the widow's shareholding in P Ltd was not relevant business property for the purposes of s104, having regard to s105(3). The appellants appealed contending that the business carried on by P Ltd consisted entirely of

lending of money to related family companies and did not consist wholly or mainly of making or holding investments.

HMRC argued (i) that the loans were investments because the companies to which the loans were made were themselves investment companies and were in common ownership and control and were controlled by the widow, either alone or with her husband and children; (ii) the sole purpose of P Ltd was to provide the other family-owned investment businesses with the means to acquire investments and so the activities of P Ltd were an extension of the family's investment activities; and (iii) the loans made by P Ltd were not made on the same terms as loans made by a third party; a third party would have assessed the risks of the loan by reference to the history of the borrowing company; the purposes of the loan, the credit-worthiness of the borrowing company; the terms of the repayment and the security offered. Because of the links between P Ltd and the borrowing companies such assessment was unnecessary because there was minimal risk.

***The decision: SpC (Dr Nuala Brice)***

**Looking at all the facts in the round, the business carried on by Phillips Ltd at the date of Mr Phillips' death did not consist wholly or mainly of making or holding investments.**

If one started with the definition in IHTA 1984 s105(3) (making or holding investments), and asked whether on its ordinary meaning the business of the company fell within it, the answer was no. P Ltd did not make or hold investments; it made informal loans to its related companies and money lending was not normally regarded as investment. The criteria for making each loan were whether the borrowing company could afford to make the interest payments and whether the value of the purchased property was commensurate with the amount of the loan. Dr Brice accepted that the main object of P Ltd, as set out in its memorandum of association, was to acquire land and buildings for the purposes of investment only but the fact was that, since 1989, that was not what it had done. What it had done was to concentrate on another object which was to lend money to its related companies. That was the actual activity of the company in June 2001 which was the relevant date for the purposes of the appeal. Also, at the relevant date, the company's main purpose was to support the related family companies by providing them with unsecured finance without fees or delays.

All the loans were repayable on demand with no security which also indicated that the loans were not in the nature of investments. **P Ltd was in the business of making loans and not in the business of investing in loans.** The loans were not assets acquired or held by the company for the purpose of making profits for division among the shareholders but were rather made for the purpose of providing a benefit to the other companies. P Ltd did not acquire any interest in the shares of the borrowing companies, or in the acquired properties, or any rights in the increased value of the purchased properties. All it was entitled to was the interest payable to it by the borrowing companies.

Turning to HMRC's submissions, Dr Brice considered that in relation to (i), the first loan was made to the estate agency company which was accepted by HMRC to be a trading company. In addition, if a loan was not an investment, it could not be made into an investment by the fact that the company to whom the loan was made was in common ownership and control or was controlled by the deceased and her family. P Ltd did not itself own any shares in the related companies. As regards (ii), the fact that a loan was made to an investment company did not make the making of the loan an investment. Lastly, in respect of (iii), the purposes of the loans

was to enable the borrowing companies to invest in real properties and the criteria for each loan were whether the borrowing company could afford to make interest payments and whether the value of the purchased property was commensurate with the amount of the loan. Whilst P Ltd took no security, and that differed markedly from any loan made by a third party, that did not convert the business of making loans into the making or holding of investments.

Accordingly the appeal was allowed.

*(Phillips and others (executors of Phillips, deceased) v HMRC Commissioners SpC 555 26.7.06 reported at [2006] SWTI Issue 32)*

### **Comment**

This decision, the latest on the section 105(3) issue, is hardly surprising. But the facts are unlikely to be replicated in large numbers of cases.

## **6. Pre-Owned Assets: HMRC's Guidance Revised on Loans**

### **Context**

Recently, HMRC have confirmed that loans to enable someone to acquire property do not satisfy the contribution condition. However, the latest version of the Questions and Answers between the professional bodies and HMRC are inconsistent with HMRC's confirmation.

### ***The Question put by the Professional Bodies***

The meaning of the 'provision' of 'consideration' in the context of the contribution condition needs to be clarified. On the basis of the case law the word provided suggests some element of bounty. On this basis our view is that if there is a transfer of Whiteacre by A (or another asset) to his son at full market value which is then sold by son and the sale proceeds used to purchase Blackacre for A to occupy, this is a breach of the disposal but not the contribution condition because it lacks the necessary element of bounty. Similarly, the provision of a loan on commercial terms by A to his son to enable son to purchase a house which A then occupies in our view does not fall within the contribution condition.

### **Question 32**

Do HMRC agree with this analysis?

### **HMRC's Answer to Question 32**

***In our view, it is arguable that the contribution condition does not depend on a degree of bounty for its application. If, on the contrary, a degree of bounty was necessary, might not the operation of the contribution condition provisions in paragraphs 3(3) and 6(3) of Schedule 15 be circumvented by the relatively simple expedient of A, in your example, providing the wherewithal for the purchase of a house by his son by way of a loan, ostensibly on commercial terms, which is then left outstanding indefinitely?***

***Having said that, we have considered further the sort of case where a loan is made and operated on commercial terms eg a commercial rate of interest is specified and paid and there***

are provisions for repayment of the loan over the sort of period one would expect to find in a truly commercial loan. Having regard to paragraphs 4(2)(c) or 7(2)(c) of Schedule 15, the chargeable amount would depend on the value of DV in R (or N) x DV/V: that's to say on 'such part of the value of the land/chattel as can reasonably be attributed to the consideration provided by the chargeable person'. **In the case where the loan is on truly commercial terms and conducted in a truly commercial way, we would accept that the attributable amount is nil or de minimis.** In determining 'reasonable attribution' for the purposes of para. 4(2)(c), it is the terms on which the loan is made and operated that are relevant, as indicated above. In that context, the period over which the loan is repaid as well as whether a commercial rate of interest is charged is relevant. Thus, where an interest-free loan is repaid over a typical 'commercial' period, it would be reasonable to regard the interest foregone as attributable to the consideration provided by the chargeable person. In cases where the principal of the loan was left outstanding indefinitely, such principal could reasonably be regarded as attributable to the consideration provided.

### **Comment from the CIOT**

Following further CIOT representations to HMRC this HMRC response is now accepted to be wrong – see Guidance Notes issued on 30<sup>th</sup> May 2006 and para 1.2.1 **'HMRC do not regard the contribution condition set out in schedule 15 para 3(3) as being met where a lender resides in property purchased by another with money loaned to him by the lender. Our view is that since the outstanding debt will form part of his estate for IHT purposes it would not be reasonable to consider that the loan falls within the contribution condition even where the loan was interest-free.'**

*(Document: Matters on which HMRC view is sought in relation to pre-owned assets income tax. Paper submitted on behalf of STEP, CIOT and LITRG, answers as revised on 31<sup>st</sup> July 2006)*

### **Comment**

Maybe the situation is not quite so straightforward as suggested above, i.e. there is not simply a conflict between what is currently said by HMRC (a) in response to question 32 and (b) in the revision to their Guidance Notes. In relation to the latter, what if father then writes off or assigns, say to his daughter, the loan? It is no longer part of his estate and if he survives for seven years the PET becomes exempt. Indeed, subject to general anti-avoidance principles, suppose that the structure was initiated in the first place with a loan on the basis of relying on the HMRC statement, but with the clear intention that fairly shortly thereafter the loan would indeed be written off or assigned? Would one be quite so sanguine about avoiding the contribution condition in such circumstances?

## **7. FA 2006 Sch 20: Transitional Serial Interests**

### **Context**

There has been some discussion about whether a TSI can arise under Sch 20 at all in two situations.

***TSIs only in part?***

First, when a pre-22<sup>nd</sup> March 2006 life interest is terminated only in part (e.g. A has a life interest in a trust and half is appointed on continuing interest in possession (IIP) trusts for his son before 6<sup>th</sup> April 2008) and second where an IIP only exists in part of the settled property from the outset e.g trust holds half the fund on IIP trusts for daughter X which arose before Budget Day 2006 and half on continuing A&M trusts for son Y who is not yet entitled to an IIP. In these circumstances can X's interest be ended in whole or part to appoint an IIP for Z?

HMRC have indicated at present informally that they agree that in both the above examples where new IIPs arise, A's son and Z take TSIs. In other words it is not necessary to terminate the pre-Budget Day 2006 interest in possession in its entirety or for the IIP pre-Budget Day 2006 to exist in the entirety of the settled property for TSI treatment to be available on the new IIP.

***More than one TSI in settled property?***

It is also possible to have more than one TSI arising in settled property e.g. T's life interest is terminated as to half with one quarter going to S and one quarter going to R. The termination of T's life interest could be done at several different times but one could not have S taking one quarter as a TSI and then S's interest being terminated in favour of R. In these circumstances R's interest would not be a TSI.

STEP and CIOT are writing jointly to HMRC for confirmation on this point with some analysis of the legislation and various other queries have arisen from the Sch 20 legislation which are also being raised with HMRC in the letter by STEP/CIOT.

A copy of the letter and response will be published in due course on the respective websites of STEP/CIOT.

The fact that such questions are being aired in the public domain illustrates the degree of nervousness at large in applying the new regime. But HMRC's reported response seems sensible, at least, to be confirmed in due course.

**8. A&M Trusts Entering the Relevant Property Regime on 6<sup>th</sup> April 2008: Exit Before the Next 10-year Charge**

***Context***

Note first that it is not necessarily the case, as was stated the Government at and following Budget 2006, that trustees of A&M Trusts in existence on 22<sup>nd</sup> March 2006 (Budget Day 2006) have until 6<sup>th</sup> April 2008 to decide what to do. If an interest in possession arises between Budget Day 2006 and 6<sup>th</sup> April 2008, it will (unless an 'age 18-to-25' trust) constitute a new relevant property trust on or after Budget Day 2006, with IHT implications accordingly.

***The scenario***

Suppose, however, that the trustees of such an A&M settlement have determined before 6<sup>th</sup> April 2008 not to wind the trust up or to change the terms to vest capital at 18 or to create an age 18-to-25 trust and the trust simply enters the relevant property regime. The first ten-year anniversary under that regime will arise on the anniversary of the commencement date of the

settlement (that is when property first became comprised in it, under IHTA 1984 s61) and the charge will be computed in the usual way. What happens, whatever, if a day or more before that 10-year anniversary there is an exit of capital eg, to one or more beneficiaries outright? It has been erroneously suggested that there is no scope in the legislation for fixing a rate of tax in such circumstances with the result that such an exit could be made with IHT impunity, whatever the amount. Sadly, this turns out not to be the case.

**Example**

Consider the following Example of an A&M settlement made by Reginald for his three children on 1 June 1996, a day on which he also made an interest in possession trust for his sister with £125,000 and when he had a 7 year chargeable transfers history of £100,000. The capital settlement becomes a relevant property settlement on 6 April 2008 with the first ten-year charge arising on 1 June 2016. Consider an exit of property on say 31 May 2016.

The chargeable amount is fixed under s65(2) as that by which the relevant property in the settlement is reduced, whether in whole or in part. The rate is found under s69 'rate between ten-year anniversaries' (s68 'rate before first ten-year anniversary' not applying). Under s69(1) this is 'the appropriate fraction' (ie depending on the number of quarters that have elapsed since the last anniversary) of the rate at which it was 'last charged under s64 (or would have been charged apart from s66(2))' Section 66(2) then applies where, as in our case, property which was comprised in the settlement immediately before the most recent ten year anniversary [viz 1 June 2006] but was not then relevant property has become relevant property. And s69(3) provides that, for the purposes of the exit charge, the assumed previous ten year anniversary charge adopts the value of the property when it became relevant property, with, however, under s69(4) a discount in calculating the exit charge for the number of complete quarters since the ten year charge during which it was not relevant property.

Assume that the value of the trust fund of Reginald's settlement on 1 June 2006 was £1m and on 6 April 2008 £1.2m. The trustees advance the whole fund (now worth £2m) to Reginald's children in equal shares on 31 May 2016. What is the exit charge?

	£	£
Chargeable amount		2,000,000
Rate:		
Deemed transfer on 1 June 2006		1,200,000
Deemed cumulative total	100,000	
Related settlement	<u>125,000</u>	<u>225,000</u>
		1,425,000
Nil-rate band 2006/07		<u>(285,000)</u>
		<u>1,140,000</u>
IHT @ 20%	£228,000	
Effective rate	<u>228,000</u>	
	1,200,000 = 19%	

Appropriate fraction:  $3/10 \times 32/40 = 0.24$

Exit charge:  $£2,000,000 \times 19\% \times 0.24 = \underline{£91,200}$

**Comment**

Note that, depending on the level of the nil-rate band in 2016/17, it may be cheaper to accept a ten year anniversary charge on 1 June 2016 and pay out the capital before 1 September 2016 with no further IHT liability.

**9. Reverter to Settlor Trusts Under the FA 2006 Regime**

**Context**

The twin capital tax advantages of reverter to settlor trusts are as follows. For IHT purposes, there is an exemption from IHT under IHTA 1984 s53(3), so that any appreciation in value in the trust property between entering and leaving the settlement escapes IHT. And, provided that the settlement continues and the property does not immediately vest outright in the settlor, there is the CGT-free uplift to market value on death accorded by TCGA 1992 s72(1)(b). Where, however, the property vests outright, the settlor is treated by s73(1)(b) as having taken the property at the trustees' (indexed) base cost. The accepted wisdom therefore has been to have the property revert to the settlor on a life interest trust, with power to advance capital which the trustees would then exercise.

***What is the effect of the new regime on the above structure?***

While the CGT-free uplift will be achieved, there will be no IHT relief, as on the death of the life tenant the trust will enter the 'relevant property' regime. To secure the IHT relief, the property must vest outright, so losing the CGT-free uplift.

Most likely the IHT advantage would be preferable – except in a case where 100% BPR or APR is available. However, this is one situation where urgent action might be required now, for example to change the terms of the trust so as to provide for the automatic entitlement to capital; once the life tenant has died, perhaps unexpectedly, it will be too late.

***Application: is there any point now in creating a reverter to settlor trust?***

Consider, for example, one traditional use, viz on father's death (mother surviving) where he might leave his half of the house to his daughter who would then, subject to some caveats (eg bearing in mind IHTA 1984 s143) make a reverter to settlor trust on her mother for life, remainder to daughter for life with power of advancing capital. Recognising that such a trust would enter the relevant property regime, it would still be effective both to ensure mother's security of tenure and to facilitate the CGT relief for the trustees on selling at a gain under TCGA 1992 s225, assuming always that mother is a person entitled to occupy for purposes of the Trusts of Land and Appointment of Trustees Act 1996.

There would be no question of a CGT-free uplift on her death, though the property could be sold shortly thereafter, with it is hoped the benefit of main residence relief and the proceeds advanced to the daughter. There would be no reverter to settlor exemption from IHT, even if an absolute reverter were provided in the trust, but the IHT cost should be zero if the exit happened within the first ten years and thereafter with only a small cost (if any) under the relevant property regime to the extent that the then value of the property exceeded the nil rate band at a ten year anniversary.

## 10. Excluded Property and GWR: Which Takes Priority?

### **Context**

The issue is the IHT status of non-UK property within a settlement made by someone both actually and deemed domiciled outside the UK in which he reserves a benefit, dying at a time when he has become actually or deemed domiciled in the UK (without releasing the benefit). Do the excluded property rules in IHTA 1984 s48(3) take priority over the GWR rules in FA 1986 s102(3)?

What was then para D8 of the Inland Revenue Advanced CTO Instruction Manual (now para IHTM 13496 of the Inheritance Tax Manual) had been changed by the end of 2001. The previous example was as follows:

*'The donor, who is domiciled in Australia, puts foreign property into a discretionary trust under which he is a potential beneficiary. He dies five years later domiciled in England and without having released the reservation. The property is property subject to reservation and is therefore deemed to be part of the donor's death estate. However, as he was domiciled outside the UK at the time the settlement was made, the property will be excluded property, under IHTA 1984 s48(3), if still situate outside the UK at the date of death.'*

The change made by the beginning of 2002 (though I am not quite sure when) replaced the final sentence with *'Any cases where this is the situation must be referred to the litigation team'* or, as now appears, *'Refer any cases where this is the situation to Litigation (IHTM 01083)'*.

### **The impact of IHTM 14396**

The change notwithstanding, HMRC Capital Taxes are still generally thought to give priority to excluded property. This has been confirmed by a posting on the Trusts Discussion Forum. Paul Kennedy wrote to HMRC in November 2005 asking for confirmation of current practice. The reply in writing was that the longstanding position (as described in para 7 of the Law Society's Gazette on 10.12.86) would remain the current view of HMRC unless and until they were to issue advice to the contrary.

The warning is made that if the property were to cease to be subject to a reservation before the end of the relevant period, HMRC could still pursue a claim for a deemed PET which had become a chargeable transfer under FA 1986 s102(4).

### **Comment**

Although it is helpful to have recent confirmation from HMRC, anyone dealing with excluded property settlement *de novo* needs to warn clients of the sword of Damocles hanging over them, though there is no knowing when, or even if, it might fall.

## C. MISCELLANEOUS

### 11. Capital Sums Treated as Income

#### **Context**

Certain sums which are capital in general trust law are deemed to be income for tax purposes, for example, a company purchase of its own shares and certain lease premiums. TA 1988 s686A has been amended to introduce a common charging mechanism for the various types of capital receipt currently assessable to income tax in the trustees' hands under a variety of charging mechanisms.

#### ***The effect of s.686A from 2006/07***

These sums are now all chargeable at the special trust rates (32.5% in respect of income that is treated as dividend income and 40% in respect of other deemed income). They include three types of capital sum (certain lease premiums, transactions in deposit rights and certain transactions in land) which have previously been treated as income but have not until now been chargeable at the special trust rates. The 'Exceptional deductions' entry at box 13.22 in the Trust and Estate Return, previously used to record these three types of capital sum so that the special trust rates did not apply to them, will be withdrawn.

Income tax chargeable at the special trust rates (excluding any amount covered by a non-payable or notional tax credit attaching to the deemed income) in respect of all these capital sums will now be included in the tax pool for the purposes of TA 1988 s687(3). So, for example, the additional tax payable on chargeable event gains will now enter the tax pool but the notional tax credit of 20% will not.

The capital sums which are treated as income are payments from or gains or profits arising on:-

- a company purchase of its own shares;
- chargeable event gains on contracts for life insurance etc;
- the disposal of deeply discounted securities, where the trustees are resident in the UK;
- lease premiums;
- the disposal of futures and options;
- the disposal of deposit rights;
- the disposal of foreign dividend coupons;
- chargeable event gains arising to Employee Share Ownership Trusts;
- offshore income gains; and
- the disposal of land, to which TA 1988 s776 applies.

*(HMRC Tax Bulletin 84 August 2006 p4)*

#### **Comment**

Something like this had to be expected at some time. The change means that if, in the context of IHT mitigation for the family home, X gives his house to trustees for his grandchildren (though of course he is unlikely to do this if the value does not exceed £285,000!) and they

grant X a lease for life at full consideration, the income element of the premium paid on what is a lease for less than 50 years now attracts income tax at 40% rather than, as before 2006/07, at 22%.

## 12. Settlor-Interested Trusts: Who Pays the Tax?

### Context

Our Summer 2006 Bulletin Item 8 noted the FA 2006 change to TA 1988 s686(2)(b), with the effect that, whereas before 2006/08 the trustees' liability to the rate applicable to trusts would not apply to income of a settlor-interested trust, it now does. The question therefore is how things work out in practice.

The issue was put by the CIOT Capital Taxes Sub-Committee (to which we both belong) to HMRC whose reply has now been received. Incidentally that letter also raised:-

- a technical issue relating to ownshare purchases following on from the new TA 1988 s686A; and
- whether the outstanding trust modernisation issues on income streaming/tax pools and deceased estates are still in contemplation.

### HMRC's response

ITTOIA 2005 s624(1) treats income of a settlor-interested trust as the '*income of the settlor and of the settlor alone*'.

ITTOIA 2005 s622 states that the person liable to tax is the settlor.

ITTOIA 2005 s646(8) says that '*nothing in section 624 .... is to be read as excluding a charge to tax on the trustees as persons by whom any income is received*'.

The current code, whereby the income is treated as that of the settlor for all tax purposes dates back to changes made in 1995. The subsections mentioned above have been part of the current code since then - s624(1) previously appeared as TA 1988 s660A(1) and s646(8) as TA 1988 s660D(3). Before changes were made in 1995 the majority of the tax charges on the settlor under TA 1988 Part XV were for the purposes of higher rate tax only (or surtax if one goes back earlier than 1972).

Since 1995 therefore there has been an overlapping charge on both the trustees and on the settlor. Tax paid by settlor-interested trusts does not enter the tax pool and is not available to beneficiaries. Section 646 sets out the relationship between settlor and trustee and, recognising the fact that the settlor is being taxed on income he or she may never receive, gives the settlor power to require the trustees to reimburse any tax liability suffered by the settlor under s624.

Looking at the overall picture, we have a regime which treats the income arising under a settlement as that of the settlor and no other person, but also expects the trustees to reimburse the settlor for any additional tax suffered as a result of their income being deemed to belong to the settlor. In the absence of s646(8) no tax would be payable by the trustees, but they would

be required to make good the tax paid by the settlor on the income deemed to the settlor's under s624.

It is relevant that s646(8) provides for a charge on the trustees as recipients [in fact, it provides that *'Nothing in sections 624 to 632 is to be read as excluding a charge to tax on the trustees as persons by whom any income is received'*]. In the context of the underlying purpose of the settlements legislation (which is to ensure that tax is paid at the settlor's marginal rate - not to tax income twice), the tax paid by trustees of settlor-interested trusts is treated as tax paid on behalf of the settlor. Take the simple example of the trustees of a settlor-interested trust receiving property income of £10,000.

In the year ended 5 April 2006, assuming a higher rate settlor and ignoring the starting rate, the situation is as follows:

Trustees	10,000 @ 22%	£2,200
Settlor	10,000 @ 40%	£4,000

If HMRC did not treat the tax paid by the trustees as paid on behalf of the settlor HMRC would collect £6,200 tax on £10,000 of income. HMRC do not do that - the SA return gives credit for tax paid by the trustees at the appropriate rate. On the 2005/06 return settlors are asked to use boxes 7.4 to 7.6 for basic rate tax items and boxes 7.10 to 7.12 for dividend rate items.

### ***What has changed?***

FA 2006 amended s686 so that settlor-interested trusts (provided they are discretionary or accumulation trusts) are no longer taken out of the charge at the special trust rates (40% and 32.5%). So, using the same example as above, the situation in 2006/07 is as follows:

Trustees	10,000 @ 40%	£4,000
Settlor	10,000 @ 40%	£4,000

As before, HMRC will still treat the tax paid by the trustees as paid on behalf of the settlor and HMRC will not collect £8,000 on £10,000 of income. Guidance will be provided in the 2006/07 SA return and credit will be given for tax paid by the trustees by using the relevant boxes on the trust pages. The credit will be given at the appropriate rates and (leaving aside the 10% non-repayable credit on dividend income) the tax will be available for repayment if the settlor is not a higher rate taxpayer.

### ***Compliance mechanism***

Concern has been expressed about the lack of a formal mechanism and HMRC have also been asked how, in the absence of forms R185, the settlor is supposed to know what to put on the return. Forms R185 are used for payments to beneficiaries and are not appropriate for the deemed income of the settlor. HMRC's assumption is that settlors are given the necessary information by the trustees in an informal manner. This is not a new issue - without the trustees passing this information to settlors it is difficult to see how settlors have been able to complete their SA returns over the last 11 years.

*(Letter from CAR Charity, Assets & Residence Trusts Head Office to CIOT 7.9.06)*

**Comment**

This really does not make us much the wiser: it certainly does not explain why it was thought necessary in the corridors of power to repeal s686(2)(b)(ii). And, in the case where the settlor is only a basic rate taxpayer, one has the cashflow and administrative inconvenience of his having to recover the excess tax paid from HMRC.

**NOTE: You should not act (or omit to act) on the basis of this Bulletin without specific prior advice.**

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