Planning with owner-occupied property - relevant case law

Synopsis: Important case law relating to the uses of owner-occupied property in estate planning.

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Wolff v Wolff - consequences of the lack of understanding

In Wolff and another -v- Wolff and others, [2004] All ER (D) 28, decided in September 2004, Mr and Mrs Wolff were the freehold owners of a property in London. In January 1997, they discussed with their solicitors an IHT saving scheme, the purpose of which was to remove the property they owned from their estate for IHT purposes while allowing them to carry on living in it. In June that year, the scheme was implemented. This, amongst other things, involved granting a reversionary lease of the property in favour of their daughters for 125 years starting from June 2017.

Subsequently, the parents became aware that, from June 2017, they would have no right to stay in the property and were at the mercy of their daughters or their successors in title to the lease. They then applied to the Court to have the lease set aside, on the grounds that they made a mistake as to its effect. The application was unopposed. The Court granted their application, on the grounds that their mistake was serious enough. It was said that "the claimants intended to give away an interest in the property to their daughters but there were limits to that gift. The effect of the transaction was that they had given away more than they had intended". As such it would be inequitable to allow the transaction to stand.

This case illustrates the potential problems with complex tax avoidance schemes. Reversionary lease schemes have of course become less attractive since the introduction of the pre-owned assets tax (POAT) in the Finance Act 2004 and had Mr and Mrs Wolff not succeeded with their application, they would have had to decide whether to opt back into the IHT net or pay the POAT (income tax) from the next tax year. So, perhaps they got a "better" result by having the lease set aside by the Court (although we do not know what costs were involved in the Court application). More importantly, what if the daughters (or their successors) opposed the application or if the application failed for another reason and, possibly, a family disagreement arose and the failed IHT "schemers" found themselves without a home 13 years later?

One must wonder how many individuals who have entered into such complex schemes truly understood the legal effects of all the transactions involved. The practical consequences of any transaction entered into as part of financial planning should always be clearly explained to a client, and when gifts, especially substantial gifts, whether to a trust or outright, are involved, this is more important than ever.

Lavelle v Lavelle - family disagreements

A practical problem (namely family disagreements) is illustrated by the case of Lavelle v Lavelle & Others. The facts of the case were as follows: In 1997, Mr Lavelle

purchased a flat in Manchester in the name of his daughter. Subsequently, a dispute arose between him, his daughter and his son as to the ownership of the flat. Mr Lavelle issued proceedings against his daughter and son claiming that he had bought the flat for his own use and that the daughter had either forged his signature or tricked him into signing, unread, a letter instructing his solicitor to proceed with the purchase in her name.

The two children, as defendants, claimed that their father instructed the solicitors to put the flat in the name of the daughter, in order to save inheritance tax and that the effect was that she therefore held the flat for the benefit of herself and her brother absolutely.

When a parent transfers an asset into a child's name, there is a presumption that the intention is to pass the beneficial interest in the property to the child. However, the presumption can be rebutted by evidence to the contrary. The High Court judge decided in May 2003 that there was sufficient evidence that Mr Lavelle was buying the flat for his own use and therefore the presumption was rebutted. Accordingly, he found in favour of Mr Lavelle. The two children appealed to the Court of Appeal. Although the Court of Appeal criticised the High Court judge on a number of points, they dismissed the appeal and also the appeal against costs.

The interesting point from the case is that in both instances the judges rejected a considerable amount of evidence submitted by both sides. For example, Mr Lavelle's claims that he did not sign the relevant letter, or that he was out of the country when the letter was signed, or that he did not seek inheritance tax advice, were rejected. Indeed, it appears that it was on the basis that Mr Lavelle's evidence on those points was rejected by the Court that his children appealed against the order of costs against them which, as stated above, they lost.

It appears there was considerable evidence that, in 1996, Mr Lavelle did obtain advice on inheritance tax avoidance from a firm of accountants. There was correspondence specifically referring to making a gift of the flat to his daughter and the IHT effect of this being a potentially exempt transfer.

It should be added that Mr Lavelle and his wife were semi-retired at that time and used to spend three quarters of the year in their home in Spain, whilst Mr Lavelle spent three months a year in Manchester using the flat. However, around the year 2000, when Mr Lavelle's business fell into financial difficulty and Mr Lavelle wished to sell the flat and put the proceeds into the business, his children objected. There was also apparently a dispute between the family business and an associated business that the two children had developed.

In finding in favour of Mr Lavelle, the Court had clearly ignored the possible tax avoidance motives as well as any suggestions of dishonesty on the part of either party and made a decision based on the fact that when Mr Lavelle purchased the flat, he intended to use it. As such the fact that the daughter's name was put on the deeds simply meant that she held it as trustee for her father.

Two important points arise from this case. The first relates to the issue of a resulting trust. Merely because someone's name appears on the deeds to the property, it does not follow that this person is both the legal and beneficial owner. If the legal owner did not provide funds for the purchase, the question of whether they hold the property on resulting trust for the person who did provide the funds will always arise. The final decision will always, of course, be based on the facts of the case. The case confirms the need for a clear statement of intention rather than just relying on the actions of individuals which may be difficult to prove in Court should the need arise.

The second is the issue of inheritance tax planning by means of giving assets away. Clearly, Mr Lavelle obtained advice on this point and correspondence confirmed that the issue of transferring the flat into the daughter's name, as part of IHT planning, was at least contemplated, although there was no evidence of a final conclusion as to whether this was the main purpose of the transfer. Anyone involved in financial services should be aware of the fact that, if property is given away by a transfer of the title to another person, and yet the donor continues to use the property, such a "gift" will be a gift with reservation of benefit and therefore ineffective for inheritance tax purposes.

The most important conclusion from the case is, however, that any IHT planning with assets within a family will frequently rely on the family being "happy and united". In practice, of course, as the above case perfectly illustrates, the relationship between parents and children (or any other relatives for that matter) may sour and, as the case also illustrates, the resolution of any argument can be very costly indeed.

Lease carve-outs - the Ingram scheme

Prior to 9 March 1999, one popular method of making a gift of the private residence but avoiding the gift with reservation provisions was by way of the lease carve-out scheme. Here the original owner would transfer the property to a nominee who created a lease in favour of the original owner. The lease, which could be for a nominal rent, would be set to run for a period exceeding the original owner's life expectancy. The freehold reversion would then be gifted to children or to a suitable trust. The benefits were that the value of the lease gradually reduced the longer the original owner survived until expiry date and, after seven years, the gift of the freehold would fall outside the taxable estate of the original owner.

In the Scottish case of Kildrummy (Jersey) Ltd v CIR (1990 STC 657), it was held that a person cannot grant a lease to themself and such a transaction was therefore a nullity. However, in Ingram v CIR (1999 STC 37), the House of Lords held that the position is different under English law, as the transfer of the property into the name of a nominee does not treat that nominee or trustee as an agent for their beneficiary. The contracts in their own name with a right of indemnity against the beneficiary for the liabilities he incurs. The nominee incurs real obligations so cannot be regarded as a mere puppet.

Furthermore, the House of Lords accepted that the St Aubyn principle applies for inheritance tax as well as estate duty. The principle underlying the St. Aubyn decision (St Aubyn v Attorney General HL 1951) was that if it was possible to legally break property into two parts, a donor could retain one part for their own benefit (and that part stayed in their estate) and give away the other part. If he enjoyed no benefit from that part he gave away, there would be no gift with reservation of benefit. Consequently, in the Ingram case, the House of Lords found that no reservation of benefit existed, by virtue of a lease carve out scheme. What was comprised in the gift by Lady Ingram was the freehold shorn of her leasehold interest with the leasehold interest remaining in her estate.

The effect of the Ingram decision has been significantly restricted in relation to gifts after 8 March 1999 by provisions introduced in the Finance Act 1999 and it is necessary to consider how these may apply to the scheme under consideration.

By virtue of Section 102A Finance Act 1986 (inserted by S104 Finance Act 1999), if a gift of an interest in land is made after 8 March 1999, it is treated as giving rise to a reservation of benefit if at any time in the relevant period (the seven years before the donor´s death or, if shorter, the period from the date of the gift to the date of the donor´s death) the donor or their spouse enjoys a significant right or interest in relation to the land or is party to a significant arrangement in relation to the land. A right, interest or arrangement is significant for this purpose if (and only if) it entitles or enables the donor to occupy all or part of the land, or to enjoy some right in relation to all or part of the land, otherwise than for full consideration in money or money´s worth. A right, interest or arrangement is not significant if either...

a) It does not (and cannot) prevent the enjoyment of the land to the entire exclusion (or virtually the entire exclusion) of the donor; or

b) It does not entitle or enable the donor to occupy all or part of the land immediately after the disposal, but would do so were it not for the interest disposed of; or

c) In the case of a right or interest, that right or interest was granted or acquired more than seven years prior to the date of the gift.

The provisions will not apply where...

- The gift is itself covered by the main exemptions from inheritance tax, including transfers between spouses (e.g. where husband as sole freeholder gives wife a share so that they become co-owners as joint tenants or tenants in common);
- The retained right or interest is negligible so that the donor is virtually entirely excluded from any enjoyment of the land – (please see HMRC Manual IHTM14333 here);
- The donor pays full consideration for their occupation of that land (please see FA 1986 Sch 20 para 6 FA 1986, e.g. a market value rent or premium);

- The occupation of the land is effectively forced on the donor by some unforeseen downturn in their financial circumstances (e.g. please see the very restricted scope in Sch 20 para 6(l)(b)) FA 1986); or
- The gift is made more than seven years after the right, interest or arrangement concerned is created or entered into.

It should be noted that for section 102A Finance Act 1986 to apply there must be a disposal of an interest in possession by way of gift.

The exclusion in (c) above seems to indicate that the GWR problem can be avoided if the estate owner can undertake their planning over a 14-year window (although as we have seen, schemes if this type will now be caught by POAT).

Example

Lady Elizabeth carves out a lease for herself and her husband for 20 years on 10 March 1999. On 11 March 2006, she gives away the freehold reversion to her children - i.e. as a potentially exempt transfer (PET). Lady Elizabeth dies on 12 March 2013. The gift of the freehold reversion appears to be effective as a PET and without gift with reservation problems. The HM Treasury Explanatory Notes to Finance Bill 1999 state: "For example a lease created and retained by a donor will not be a reservation in relation to the gift of the freehold reversion made more than seven years after the creation of the lease."

Clearly any planning strategy using the private residence must, in order to be successful, avoid the potential application of section 102A. This will mean that the arrangement must either...

- Be structured in such a way as to avoid a gift; or
- The donor should carve out a lease which they keep for their own benefit together with the freehold reversion. After seven years, he can gift the freehold reversion without giving rise to a gift with reservation. Provided he then survives this gift by a further seven years, this lifetime gift will drop out of account for IHT purposes.

The POAT rules will also now need to be borne in mind.

The Ingram scheme involved a homeowner gifting the whole title in their property to a nominee. The nominee created a lease for a period of years in favour of the former owner and the remaining reversionary interest was gifted to children or on trusts for them. The arrangement involved a gift equal to the loss to the estate of the freehold reversion with the value of the lease remaining in the former owner's estate. However, as the owner approached the expiry date of the lease, its value would reduce substantially.

Legislation aimed at these schemes was introduced in Finance Act 1999, so that for dispositions after 8 March 1999, the lease that entitles the donor to occupy the land constitutes a 'significant right or interest' and causes the property disposed of to be property subject to a reservation unless...

i. the lease is granted for full consideration; or

ii. the gift of the interest is made at least seven years after the interest has been created and the donor survives that gift by a further seven years (section 102A(5) Finance Act 1986).

Ingram schemes that are not subject to the gift with reservation provisions, either because they were created prior to 8 March 1999 or they fall within category (ii) above, will be caught by the POAT rules as the disposal condition is met by the gift of the freehold interest. There is a corresponding exemption from POAT where full consideration is paid for occupation. Where POAT does apply, the charge may increase each year because the formula which fixes the rental value of the relevant land will change each year, because the value of the freehold interest given away will gradually increase.

Here the donor’s planning options may be…

a. To pay the donee rent equal to the increasing ´appropriate rental value´;

b. To pay income tax on the appropriate rental value;

c. To move out of the house or land; or

d. To opt back into the inheritance tax reservation of benefit regime (though the deadline for this will now have passed).

Note that, where a donor ceases to occupy the property having previously made an election, this would be a deemed potentially exempt transfer under section 102(4) Finance Act 1986.

The Eversden case (prior spousal interest schemes)

Pre-19 June 2003 spousal alienation trusts or spousal interest trusts are among those specifically targeted by the pre-owned asset legislation (spousal interest trusts created after that date give rise to a gift with reservation). If the trust holds a residential property and the initial interest in possession of the settlor’s spouse has been terminated in favour of continuing trusts for, say, the settlor’s children, the POAT rules will cause an income tax liability on the original settlor, if he continues to occupy the property. The POAT rules will not apply if he pays ´the appropriate rental value´ or has opted back into the reservation of benefit regime. If the interest in possession has ended, it is the settlor not the spouse who suffers the income tax charge because the spouse has not made a disposal under Schedule 15. Of course, if scheme is caught by the GWR rules then POAT will not apply.

If the scheme involves land, and an appointment has not been made away from the settlor’s spouse, the property is treated, for IHT purposes, as being within the estate of the spouse and so the new POAT rules do not apply. This is because it will be an excluded transaction within paragraph 10(1)(c) of Schedule 15.

In the Court of Appeal decision in CIR -v- Eversden in May 2003 the Court held that where a settlor created a trust under which their spouse had an immediate interest

in possession, then even if the settlor was a potential beneficiary under the trust, the gift to the trust would not be a gift with reservation. This was because of the exemption in section 102(5)(a) Finance Act 1986, which states that a gift will not be a gift with reservation "to the extent that the disposal of property by way of gift is an exempt transfer by virtue of...the spouse exemption." The impact of the inheritance tax legislation was to treat the settlor´s spouse as owning the trust capital supporting the interest in possession, so the Court found that the gift was fully covered by the spouse exemption.

This meant that a later appointment of benefits by the trustees away from the spouse in favour of say children, even if only a short time thereafter, would mean that the trust property would be outside of the gift with reservation rules even though the settlor could, at a later date, benefit from the trust. The Eversden case was concerned with a trust of the private residence but some life offices offered arrangements that facilitated this planning using single premium bonds.

In the Court of Appeal, the Inland Revenue argued that the gift by the settlor was, in reality, a gift of several interests in property, some of which were caught by the gift with reservation rules and some which were not. The Court of Appeal rejected this argument and, in finding in favour of the taxpayer, suggested that if the Government wished to stop this type of tax avoidance, it may be more appropriate to change the law.

The Government took note of this "advice" and during the Finance Bill 2003 debates announced a change to the Finance Bill which prevents such planning in respect of trusts created on or after 20 June 2003.

The new provisions (now embodied in sub-sections (5A) and (5B) to section 102 FA 1986) disapply the previous exception from the gift with reservation provisions in section 102(5)(a), Finance Act 1986 for gifts to a spouse where gifts are made after 19 June 2003 where...

- The property becomes settled property by virtue of the gift;
- The trusts of the settlement give an interest in possession to the donor´s spouse, so that the gift is exempt from IHT by reason of the exemption for transfers between spouses and the rule which treats an interest in possession as equivalent to outright ownership;
- Between the date of the gift and the donor´s death the interest in possession to the spouse comes to an end; and
- When that interest in possession comes to an end, the donor´s spouse does not become beneficially entitled to the settled property, or another interest in possession in it.

In applying section 102 in these circumstances, the original disposal by way of a gift will be treated, where relevant, as having been made immediately after the donor´s spouse´s interest in possession ends, so that the circumstances before that

time will not be considered in determining whether the gifted property is "property subject to a reservation" for IHT purposes.

Trusts set up before 19 June 2003 remain effective for inheritance tax purposes but will be caught by the POAT charge unless the deemed annual benefit is within the de minimis limit or the settlor has been excluded from benefit.

The Lloyd's Private Banking and Faulkner cases - gift to children via the will but with protection for surviving spouse over time of sale

The High Court decision in Lloyd´s Private Banking Ltd v IR Commissioners (1998) appears to have confirmed the Inland Revenue reasoning on the existence of an interest in possession in such cases. The decision is interesting because in this case the deceased left her share of the house to her daughter (i.e. without a formal trust, apparently denying any possibility of arguing that the surviving spouse was a trust beneficiary) but with provision that the surviving spouse was to be permitted to continue residing in the house until his death providing he paid all the outgoings. It was held that the effect of the provision was to confer on the widower a life interest (i.e. interest in possession) in the half share passing on his wife´s death. In particular, it was said that the survivor´s own rights as tenant in common were not enough to entitle them to exclusive occupation of the whole of the property for the rest of his life. Based on this decision, it would seem that almost anything other than an outright and unconditional gift for the benefit of the children, excluding the co-owner from benefit, could fail on this point.

In Faulkner (Trustee of Rupert Charles Adams deceased) v Inland Revenue Commissioners, a house was left by will on trust for residuary beneficiaries but with directions to the trustees to permit a married couple to live in the house for as long as they wished. The trustees had no right to sell the property. It was held that the couple, and then the husband on his wife's death, occupied the house under a direction in the will. The trustees had no discretion over this and no power to prevent it. Thus, at the time of the husband's death, he had a present right to present enjoyment of the house, and thus an interest in possession. The residuary beneficiaries did not have a present right in the house until the death of both the husband and wife. The transfer of the wife's interest to her husband when she died was, of course, exempt under the spouse exemption.

Discretionary will trusts – the Judge case

This Special Commissioners' decision in Judge and another (representatives of Walden deceased) cast doubt on HMRC's position as set out by SP10/79.

The facts of the case were that the deceased testator, Mr Thomas Walden, gave to his trustees all his interest in property at 30 Perrymead Street, London upon trust (with the consent of his wife in writing during her lifetime) for sale and further declared that the trustees during the lifetime of his wife should permit her the use and enjoyment of the property "for such period or periods as they shall in their absolute discretion think fit", his wife paying the outgoings. Mr Walden died in 2000 and his wife died in 2003.

On the death of Mrs Walden HMRC issued a notice of determination because they were of the view that she had enjoyed an interest in possession in the property she occupied as her principal residence. Her personal representatives believed that there was no interest in possession.

There were also the following issues...

- A clear statement in a letter from the trustees to the settlor´s spouse indicating that she did have an interest in possession.
- A consideration of the legal principles to be applied to the construction of a will and, in particular, the extent to which extrinsic evidence could be relied on in that construction.
- The impact, if any, on the existence (or not) of an interest in possession, of the widow's right to prevent the trustees selling the property by withholding her consent.
- The importance or otherwise of the perceived intentions of the deceased, and what evidence could be used in support of such intentions.

Clause 3 of the deceased's will provided the following...

"I GIVE free of tax and of any monies secured thereon by way of legal charge or otherwise to my Trustees ALL THAT my interest in the property known as and situate at 30 Perrymead Street London SW6 OR the property in which I am at my death ordinarily resident or in which I have then last been ordinarily resident UPON TRUST with the consent in writing of my Wife during her lifetime to sell the same with full power to postpone sale for so long as they shall in their absolute discretion think fit and to hold the net proceeds of sale and other monies applicable as capital and the net rent and profits until [sale] upon the trusts and with and subject to the powers and provisions of my Residuary Fund (as hereinafter defined) as an accretion thereto AND I DECLARE my Trustees during the lifetime of my Wife to permit her to have the use and enjoyment of the said property for such period or periods as they shall in their absolute discretion think fit pending postponement of sale she paying the rates taxes and other outgoings and keeping the same in good repair and insured against fire to the full value thereof in some office of repute nominated by my Trustees in the names of my Trustees."

So, from the words, it can be seen that, even though the testator's spouse had the sole right to postpone any sale by withholding her consent, and the trustees were directed to permit the surviving spouse to live in the property, this permission was to be given for as long as the trustees "in their absolute discretion" thought fit.

The main argument was quite straightforward. The personal representatives of the deceased Mrs Walden maintained that the fact that Mrs Walden's occupation had to be "for such period or periods as (the trustees) shall, in their absolute discretion, think fit" clearly indicated that the trustees had discretion and that clause 3 was not a direction to them. As a result, Mrs Walden did not have an interest in possession.

To have this she would have to have been entitled to the “current right to current enjoyment” No such "right" existed.

Another supporting argument was that the expression in the will that the conveyance onto trusts was to be "free of tax" was consistent with the fact that a discretionary trust was intended. If it were intended to create an interest in possession for the spouse this would have been exempt and there would have been no need to use these words. Lastly, it was argued that if the creation of an interest in possession had been intended it could have been done much more simply and clearly. The Lloyds, Woodall and Faulkner cases were all distinguished as in each of these cases there had been an enforceable right to reside given to the surviving spouse unlike in this case where occupation was dependent on the exercise of the trustees´ discretion.

Mr Peter Twiddy, for HMRC, argued that it would have been odd if Mr Walden (the original testator) had intended that his wife could be moved out of the house they had occupied together for "quite a long time". He said no weight should be attached to the "free of tax" phrase as it was often included in wills where there was no strict need for it to be included. It was also argued that if a discretionary trust had been intended this would have resulted in IHT being due on his death which may have resulted in the house having to be sold to pay the tax which is something Mr Walden would be unlikely to have wished to happen. Finally, reliance was placed on Lloyds and Woodall in arguing that the true effect of clause 3 meant that there should be no sale of the house so long as Mrs Walden wished to reside there. This contention is interesting. There was no doubt that the trustees had to seek Mrs Walden’s consent to sell the property. One of the reasons she may wish to withhold consent (probably the overwhelming one) would be to continue in residence.

However, the two terms had to be looked at separately. It would be possible for the trustees to fail to secure consent but they could also exercise their discretion to prevent the withholder of consent (Mrs Walden) from occupying or exclusively occupying the property. The HMRC contention that there was an interest in possession appears to have been supported by the trustees – Commercial Union Trustees - in a letter to the testator’s widow. The letter read as follows:-

"I would confirm that under clause 3 of your late husband’s will, 30 Perrymead Street is the sole asset of a Life Interest Trust and you will enjoy the occupancy of the property during your lifetime … you will be responsible for the actual payment of the premiums (for buildings insurance cover) as well as all the household bills etc. including council tax …

Under Clause 4 of the will the residue of the estate is to be held on a discretionary trust for the benefit of yourself, your nephew and niece and also their children. As trustees, we have the responsibility of exercising our discretionary powers under the terms of the will and also under trust law when considering making payment of capital and income to the discretionary beneficiaries …

This discretionary trust is slightly different in as much that you, as the surviving spouse, are not nominated as the "primary beneficiary" …"

On the face of it this would appear to have been tremendously helpful to HMRC´s cause and they sought to rely on this extrinsic evidence in the interpretation of the will referring to section 21 of the Administration of Justice Act 1982. This provides that:

"21(1) This section applies to a will –

> a) in so far as any part of it is meaningless;
>
> b) in so far as the language used in any part of it is ambiguous on the face of it;
>
> c) in so far as evidence, other than evidence of the testator's intention, shows that the language used in any part of it is ambiguous in the light of surrounding circumstances.
>
> d) In so far as this section applies to a will extrinsic evidence of the testator's intentions, may be admitted to assist in its interpretation."

The Special Commissioner stated that they should give effect to the intention of the testator as expressed in the terms of the whole of the will.

There was considerable discussion over the exact meaning of clause 3 of the testator's will which contained the main dispositive provisions in respect of the private residence. The Special Commissioner emphasised the importance of considering "the four corners of the dispositive clause" and not just the one. In her consideration, she had noted the importance of the giving of the trustees the discretion (but not the duty) to permit the testator's spouse to occupy the property. Crucially, it was stated that these words were of themselves (but please see below) unambiguous and that effect must be given to them. The Special Commissioner concluded that the testator's spouse, based on this interpretation of the will, did not have the right to occupy the property in question.

However, because the wording of the main dispositive clause in the will was defective it would have to be accepted that it was, as a result, ambiguous. This would, under the provisions of the Administration of Justice Act 1982, permit reference to extrinsic evidence, including evidence of the testator's intention to assist in its interpretation.

The evidence that the Revenue sought to rely on was the letter from Commercial Union trustees. However, the papers leading to the preparation of the will had been lost and in the light of this, the Special Commissioner did not find that the interpretation of the will by the trustees, as evidenced by the letter from them to the testator's spouse, was sufficient "extrinsic evidence of the testator's intention."

Imaginatively, HMRC´s contention (in the light of the trustees' letter) was that the dispositive provision in the will that provided that the trustees should have power to permit the testator's spouse to occupy "for such period or periods as they shall in their absolute discretion think fit" should be re-written (for the purposes of

interpretation) to read "for such period or periods as she (i.e. the testator's spouse) shall in her absolute discretion think fit".

There was some relatively technical discussion over the laws of interpretation in the case of ambiguity, but the upshot was that the Special Commissioner concluded that it was not possible to rewrite the will in the way that HMRC had contended and that the clause should be interpreted based on the words actually used.

The conclusion that was reached by the Special Commissioner was that based on the accepted definition of "interest in possession" (the current right to current enjoyment) the testator's spouse did not have such a right on her death because the trustees had absolute discretion as to whether, or not, they would permit her to exercise that right.

This decision will give some heart to the users (and prospective users) of discretionary trusts. However, it must be borne in mind that this is a decision of a Special Commissioner. Despite the fact that there was no appeal, given different facts, an argument that an interest in possession in fact exists under a trust that on the face of it is discretionary may be successful. The conclusion must therefore be to proceed with caution. If a trust is to be taxed as a discretionary trust, then it must be clearly and unambiguously discretionary on its face and there should also be no admissible evidence that it is other than that.

More information on the IHT treatment of discretionary trusts since the 2006 Finance Act is available here.

The Phizackerley case

Prior to the introduction of the transferable nil rate band, one of the most effective and frequently used forms of inheritance tax planning for a husband and wife (or couple in a registered civil partnership) who wish to keep control of their assets during their lifetime was to establish nil rate band discretionary trusts in their Wills. Such trusts come into effect on the death of the first of the couple to die and utilise the nil rate band on first death while allowing access for the surviving spouse as a discretionary beneficiary.

Where investments are held in the trust, the IHT benefits can be enhanced by paying any amounts out of the trust to the surviving spouse in the form of interest-free (or interest-bearing) loans repayable on demand. If the assets subject to trust are stocks and shares or collectives the trustees could raise cash to make the loan without any tax liability at that time by using their annual CGT exemption to release capital or by using the 5% tax-deferred withdrawal facility if the trust asset is a single premium bond.

Then, the trust giving them the requisite powers, the trustees could make an interest-free loan repayable on demand to the surviving spouse. Provided they spend the money their taxable estate will not increase but, on the survivor's death, the loan would be repayable to the trust which would mean that the deceased's estate would be reduced and so the resulting IHT liability would also reduce.

The reduction in the surviving spouse's taxable estate is subject to a caveat. Section 103(1) Finance Act 1986 provides that:

"(1) Subject to subsection (2) below, if, in determining the value of a person´s estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of a debt incurred by him or an incumbrance created by a disposition made by him, that liability shall be subject to abatement to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of -

(a) property derived from the deceased; or ..."

Section 103(3) gives a very wide definition of "property derived from the deceased".

Basically, this means that, if property is transferred by a person ("A") to the deceased (whilst alive) ("B") and, at a later date, this property (or property derived from it) is lent back to A, that loan is not deductible for IHT purposes on A´s death.

This section was the subject of the Special Commissioner´s decision in the Phizackerley case.

Dr and Mrs Phizackerley bought a house in 1992. Although the house was in joint names (owned on a joint tenancy basis), Dr Phizackerley (as the only one of the couple working) provided all the funds.

In 1996, Dr and Mrs Phizackerley severed the joint tenancy so they both owned the property as tenants in common.

Mrs Phizackerley died in 2000, leaving a nil rate band legacy to discretionary trusts with the balance absolutely to her husband.

At the date of her death, the assets in her estate fell fully within her available nil rate band of £210,000. Part of this property was her half interest in the family home worth £150,000. Following her death, her husband agreed to purchase the deceased´s interest in the property from the discretionary Will trust for £150,000 index-linked. The property was transferred into his name and he gave the trustees an IOU for the purchase price.

On his subsequent death, it was argued that the outstanding debt of £156,013 (£150,000 before indexation), due to the trust, should be deductible from his taxable estate. However, Her Majesty´s Revenue and Customs (HMRC) raised the issue of section 103 Finance Act 1986 which, as will have been seen from the commentary above, precludes the deduction of a debt that was made out of property derived from the deceased, i.e. property that was given by the debtor to the creditor. It should be noted that the meaning of "derived from the deceased" in this context is extremely wide. In this particular case, because Dr Phizackerley had previously made a gift of the property to his wife out of which the debt arose, that debt was not fully deductible and needed to be abated to the extent it arose from that disposition.

However, Counsel on behalf of the taxpayer (Dr Phizackerley´s daughter) raised the argument that, for section 103(4) to apply, the disposition needed to be a transfer of value and, based on the facts, as there had been no transfer of value the amount of the debt should not be reduced.

He argued that there was no transfer of value because the original gift from Dr Phizackerley to his wife (the cash or the house) was covered by section 11 IHT Act 1984 - dispositions for the maintenance of the family because the house "provided a roof over his wife´s head". However, the Special Commissioner rejected this argument on the basis that this exemption did not apply. He said: "I do not consider that when a husband puts a house in joint names of himself and his wife during their marriage it is within the ordinary meaning of maintenance. In spite of Mr Kessler´s persuasive argument, I do not consider that the disposition is for maintenance in this case."

This case demonstrates that one has to be extremely careful when advising clients who are surviving spouses to take an interest-free loan from the trustees of a Will trust established on the death of the first spouse to die in order to create a debt on that surviving spouse´s taxable estate. In cases where the borrowing spouse had made lifetime gifts to the now deceased spouse, depending on the facts that debt may not be allowed as a deduction.

How strictly HMRC will apply this principle possibly depends on a number of factors not least the amount of the lifetime gift and how long ago it was made. It is important to note though that, in the Phizackerley case, a finding of fact was made that the gift of the money for the half share in the house was not made with reference to enabling or facilitating the giving of the consideration for the debt, i.e. the half share of the home. This would enable s103(2) to apply so that the debt would not be reduced. Counsel for the taxpayer reserved the right to contend this and will presumably now do so with this finding of fact and following the rejection of his primary argument on the application of section 11 IHTA 1984. Since the new rules on non-deductibility of certain debts were introduced in Finance Act 2013, it will also be important to ensure that the debt is actually repaid to the trust on death of the surviving spouse. If it is not, it will not be deductible.

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