

## Gifts with reservation

Synopsis: The gift with reservation of benefit provisions.

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### The meaning of “gift with reservation” with examples

There are special rules for charging gifts made by an individual on or after 18 March 1986, which are subject to a reservation of benefit to the donor (please see Finance Act 1986 sections 102, 102A, 102B, 102C, and Schedule 20). A gift with reservation arises if...

1. The donee does not assume bona fide possession and enjoyment of the property, or
2. The property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to them by contract or otherwise.

These special rules apply on the death of the donor if during the 'relevant period' any property given away has been subject to a reservation. The 'relevant period' is the period ending on the donor's death and beginning either seven years before or, if it is later, on the date of the gift. If the reservation exists at the date of death, the property is treated as part of the donor's estate for inheritance tax (IHT) purposes. The reservation of benefit rules apply only for IHT purposes. Otherwise, the usual legal and tax consequences of the gift apply, i.e. the legal ownership passes to the donee and, if relevant, a disposal takes place for capital gains tax purposes. Thus, there may be a capital gains tax liability at the time of the disposal.

#### Example 1

Alex makes a gift to their nephew of a holiday cottage. The cottage is not Alex's principal private residence and there is a capital gains tax liability arising as a result of the gift. Having made the gift, Alex continues to use the cottage regularly without paying rent to their nephew. Alex then dies. The value of the cottage at Alex's death is £100,000. The cottage was valued at £50,000 at the time that the gift was made.

As a consequence of Alex's reservation of benefit the cottage valued at £100,000 is treated as part of their death estate for IHT purposes. If the cottage had in fact remained in Alex's ownership until death there would have been no capital gains tax payable during Alex's lifetime, and on Alex's death the capital gains tax uplift would have had the effect of extinguishing the liability to capital gains tax altogether.

Instead, the impact of the gift with reservation is such that in addition to the IHT charge resulting from Alex's death, the change in ownership to the nephew during Alex's lifetime gave rise to a capital gains tax charge at the time of the gift. Furthermore, when the nephew disposes of the cottage there will be capital gains

tax to pay on the increase in the value of the cottage from the date of the gift (i.e. £50,000 when the nephew took ownership of the cottage).

A gift of property is in danger of falling foul of the reservation of benefit rules if the donor receives, or is capable of receiving, any direct or indirect benefit that is referable to the gift.

### **Example 2**

Bob transfers his house into the joint names of himself and his son. The son does not live in the house. Bob therefore occupies the entire property until he dies.

Bob's gift of a half share of the house is subject to the gift with reservation rules. This is because the son does not assume bona fide possession and enjoyment of the property and also because the property is not enjoyed to the exclusion of the donor as the donor continues to occupy the entire property without payment.

If, however, the son takes up residence with Bob and all outgoings are shared equally between them, then there will be no gift with reservation by virtue of s102(B)(4) Finance Act 1986 (please see 'Gifts of interests in land' below). Furthermore, Bob will not be subject to the Pre-Owned Assets Tax (POAT) charge as the benefit retained in such circumstances is consistent with B's ongoing enjoyment of the property.

### **Example 3**

Charles gives his house to his son. The son allows Charles to live there rent free.

The gift of the house is a gift with reservation.

### **Example 4**

Debbie is a shareholding director wishing to make a gift of some of her shares to her daughter. Debbie continues to be involved in the management of the company subsequent to the gift. Following the gift, Debbie receives remuneration and other benefits which are in excess of what would normally be considered commercial.

In these circumstances, Debbie is in danger of falling foul of the gift with reservation rules (please see *Oakes v Commissioners of Stamp Duties of NSW*). Continued remuneration or other benefits which can be seen to be on the basis of reasonable commercial arrangements should not fall foul of the reservation of benefit rules, provided the benefits were in no way linked to or affected by the gift.

If property ceases to be subject to a reservation, for instance in Example 2 above the parent moves out of the house or begins to pay a commercial rent for their continued occupation, the donor is treated as having made a potentially exempt transfer (PET) at that time. If the cessation was more than seven years before the death of the donor, the PET will have fallen out of account. If the cessation was within seven years of the donor's death, IHT will be assessed on normal principles. Note that the value of the PET cannot be reduced by any available annual exemptions.

Finance Act 2006 amended section 102 Finance Act 1986 to provide that when an individual's interest in possession is terminated during their lifetime, but the individual remains as one of the potential beneficiaries under the trust, the coming to the end of the interest in possession will be treated as a disposition by way of gift with the effect that such a disposition will become a gift with reservation of benefit.

A gift that gives rise to a charge under the gift with reservation rules may also be chargeable under the normal rules, for example, because the original gift itself was a transfer into a discretionary trust, taxable when made, or a potentially exempt transfer made within seven years before the donor's death. Any double charge is relieved by regulations contained in Statutory Instrument 1987 No 1130 - The Inheritance Tax (Double Charges Relief) Regulations 1987.

### Exceptions

The gift with reservation provisions do not normally apply to gifts that are exempt in the following circumstances (Section 102(5) FA 1986)...

- Transfers between married couples or civil partners (as modified in 2003);
- Gifts in consideration of marriage or a civil partnership;
- Small (up to £250) gifts;
- Gifts to charities and political bodies;
- Gifts to housing associations;
- Gifts for national purposes;
- Employee trusts;
- Maintenance funds for historic buildings.

The rules will not apply if the donor has been 'virtually' entirely excluded from enjoyment of the property they have given away. 'Virtually' is not defined in the legislation, but it is intended to prevent these rules from applying where the benefit enjoyed by the donor is insignificant in relation to the property given away ([Inland Revenue Tax Bulletin November 1993](#)).

For example, a gift of a house or a picture would not be a gift with reservation if the donor happened to 'enjoy' either the house or the picture on short visits to the donee.

HMRC has supplied some examples of situations in which they consider that a limited benefit is permitted to the donor without bringing the provisions into play...

- A house which becomes the donee's residence but where the donor subsequently stays in the absence of the donee for not more than two weeks a year, or stays with the donee for less than one month a year.

- Social visits made by the donor as a guest, excluding overnight stays. Such visits should be no more extensive than the donor might be expected to make in the absence of the gift.
- A temporary stay for some short-term purpose in a house that the donor had previously given away, for example convalescence following medical treatment.
- Visits to a house for domestic reasons, for example baby sitting by the donor.
- A house together with a library of books which the donor visits less than five times in any year to consult or borrow books.
- A motor car which the donee uses to give occasional lifts to the donor. Occasional in this context being less than three times a month.
- Land where the donor walks their dog or uses for horse riding, provided that such activities do not restrict the donee's use of the land.

Where the benefit to the donor is more significant the gift with reservation provisions are likely to bite, for example...

- A house where the donor stays most weekends or for a month or more each year.
- A second home which the donor and donee both use on an occasional basis.
- A house with a library where the donor continues to keep their own books or which the donor visits regularly for their work.
- A motor car in which the donee takes the donor to work every day.

There are other circumstances in which the donor's occupation of a house or land, or possession of a chattel, will be disregarded. Provided the donor gives full consideration in money or money's worth, occupation or possession will not of itself make the gift one with reservation - Paragraph 6(1)(a) Schedule 20 FA 1986.

For example, in the case of a lease, this condition may be satisfied where it is shown that both sides to the bargain have negotiated at arm's length and been separately advised and that the lease follows normal commercial criteria in force at the time it is negotiated.

There is also a special provision for the case where a donee is a relative of the donor or of the donor's spouse/civil partner and allows the donor to occupy a house, or part of it.

Broadly, the donor's occupation will be disregarded if it results from an unforeseen change in the donor's circumstances since the time of the gift, the donor has become unable to maintain themselves through old age, infirmity or otherwise and

it represents a reasonable provision by the donee for the donor's care and maintenance - Paragraph 6(1)(b) Schedule 20 FA 1986.

### **Retention of carved out interest**

It is well settled under English law that a retention of a distinct and clearly defined right in property will not amount to reservation of benefit (please see *Ingram v CIR*, 1998, UKHL 47). This means that it is possible to make a gift of property out of which the donor had carved and retained an interest without this being a gift with reservation.

Where a gift is made subject to a specific retained interest so that it may properly be said that the donor has kept something back, that interest may not be a reservation.

### **Example**

Andy effects a ten year endowment policy which is made subject to trust. Under the terms of the trust the death benefits are held for the benefit of Andy's children, but if Andy survives until the maturity date the benefits are held for Andy absolutely.

This is not a gift with reservation. The policy provides two distinct interests, i.e. the death benefit and the maturity benefit. Andy has merely given away one interest, i.e. the death benefit, and retained the other interest i.e. the maturity benefit.

### **Gifts of interests in land**

Finance Act 1999 tightened up the rules relating to gifts with reservation involving land with effect from 9 March 1999. This was in response to the House of Lords ruling in *Ingram and another v IRC* [1999] STC 37, a case involving a gift of the freehold reversion in the taxpayer's property, whilst the taxpayer continued to occupy the property rent free under a lease.

Finance Act 1986 section 102A (as inserted by Finance Act 1999) extends the gift with reservation provisions to prevent the avoidance of IHT on death by way of a lifetime gift where the donor or the donor's spouse (or civil partner) enjoy a significant right or interest, or is a party to a significant arrangement, in respect of land. Where this happens, the interest disposed of will be treated as a gift with reservation.

A right, interest or arrangement is significant if it entitles or enables the donor or the donor's spouse or civil partner to occupy all or part of the land, or enjoy some other right, otherwise than for full consideration in money or money's worth. The right is not significant if it...

- Cannot prevent another person(s) enjoying the land virtually or entirely to the exclusion of the donor;
- Does not enable the donor to occupy the land immediately after the disposal but would have done so were it not for the disposal; or

- Was granted or acquired more than seven years before the gift.

Similar provisions contained in s102B Finance Act 1986 apply to gifts of undivided shares in land. However, subsections (3) and (4) provide that there will not be a gift with reservation where...

- The donor either does not occupy the land; or occupies the land to the exclusion of the donee for full consideration; or
- The donor and donee share occupation and (broadly) the donee pays no more than their share of the outgoings.

Gifts of assets other than interests in land are not affected by these provisions and continue to be subject to the provisions of s102 as supplemented by Schedule 20.

Note also that planning with property which is not caught by the gift with reservation rules, could be subject to the POAT charge.

### **Gifts by associated operations**

A benefit which the donor obtains by virtue of associated operations of which the gift is one is to be treated as a benefit to the donor by contract or otherwise - Paragraph 6(1)(c) Schedule 20 FA 1986 and is therefore caught by the gift with reservation provisions.

### **Example**

Alan effects a whole of life policy which is made subject to a flexible power of appointment trust, or since 22 March 2006 a discretionary trust, under which his wife is a potential beneficiary. Alan is excluded from benefit under the trust of this policy. His wife also effects a similar trust policy under which her husband Alan is a potential beneficiary. She is also excluded from benefit under the trust of this policy.

Although neither Alan nor his wife retains any benefit under the policy effected by them, each has been made a beneficiary under the trust of the policy effected by the other. Due to this reciprocal arrangement both policies may well be subject to the gift with reservation provisions.

### **Replacement property**

There are rules to identify the property comprised in the donor's gift. For example, if the donee receives a gift of property other than a sum of money and exchanges that property for another asset of comparable value, the substituted property is to be treated as if it had been comprised in the gift - Paragraph 2 Schedule 20 FA 1986.

If property is settled by the gift, the property comprised in the settlement will be treated as part of the donor's estate if a reservation exists at the death, or as the subject of a PET if a reservation is given up within seven years of that death - Paragraph 5 Schedule 20 FA 1986.

## Loans to trustees

There are special provisions when a gift is made into trust, comprising a gift with reservation, and the donor makes a loan to the trustees. The property derived, directly or indirectly, from the loan is treated as part of the property comprised in the donor's gift into settlement - Paragraph 5(4) Schedule 20 FA 1986.

This provision was introduced to defeat the IHT trust plans that had been marketed before 18 March 1986. However, it is widely thought that this provision only applies where the original gift to trustees was a gift with reservation. If no such reservation exists, loans could still be advanced to the trustees without falling foul of paragraph 5(4) Sch 20 FA 1986.

## Life assurance policies and gifts with reservation

Where a life policy is effected on or after 18 March 1986 and made the subject of a trust, there will be a gift with reservation if the settlor is also a potential beneficiary under the trust. There is no reason why the settlor's spouse or civil partner should be excluded from being a beneficiary, although great care needs to be exercised to ensure that any appointment by the trustees in favour of the settlor's spouse or civil partner does not benefit the settlor, either directly or indirectly, thereby bringing the gift with reservation provisions back into play.

Life assurance policies effected prior to 18 March 1986 under which the settlor is a potential beneficiary under a power of appointment trust are not subject to the gift with reservation rules unless the policy is varied on or after 18 March 1986 (whether by exercise of an option or otherwise) so as to increase the benefits or extend the policy term (Section 102(6) FA 1986). The following are examples of changes that will be regarded as increasing the benefits or extending the term...

- Altering from one class of assurance to another.
- Converting from an endowment assurance to a low-cost endowment or vice versa.
- Reducing the term of an endowment assurance, if premiums are simultaneously increased.
- Converting from a non-profits to a with-profits policy for the same sum assured.
- Adding waiver of premium, double accident benefit or another option not previously included in the policy.

An exception is made for an increase in benefits arising from the exercise of an indexation option that had to be exercised on or before 1 August 1986 (Section 102(7) FA 1986).

If benefits under a pre-18 March 1986 policy are increased, the proportion of the proceeds secured by the premiums paid on or after 18 March 1986 will be deemed to form part of the settlor's estate for IHT purposes.

HMRC has confirmed that in the following examples where the settlor has retained an interest which they owned at outset, a gift with reservation has not been made...

- An endowment assurance policy effected by the life assured in trust for A if living at the death of the life assured before the maturity date, but otherwise for the life assured.
- A whole life policy effected by the life assured in trust for A if the assured should die before a specified date but otherwise for the life assured should he survive to that date or should A predecease them.
- A whole life policy effected by the life assured in trust for A should A survive the life assured but otherwise for the life assured.

Note that the provisions of Finance Act 2006 are such that a gift with reservation will also arise in the event that an interest in possession is terminated during the life tenant's lifetime, but that individual remains one of the potential beneficiaries under the trust.

### **PETA plans**

A gift made on or after 18 March 1986 under a policy on the life of the donor or their spouse (or civil partner), or on their joint lives, is treated as a gift with reservation if the benefits that will or may accrue to the donee vary by reference to benefits accruing to the donor or spouse (or civil partner), or both of them, under that or another policy - Paragraph 7 Schedule 20 FA 1986. This provision was introduced to defeat the discounted gift schemes using typically a pure endowment and a term assurance - marketed as PETA plans.

### **Example**

Nik takes out two policies on his own life, a term assurance and a pure endowment policy. He retains the pure endowment for himself. The term assurance is put into trust for the benefit of his son. His own policy provides for him to receive sums from the insurance company during the life of the policy, with corresponding reductions in the sum assured under the policy for his son. The gift of the policy to the son is a gift with reservation.

Revamped PETA plans are still being marketed without becoming caught by the gift with reservation provisions.

Despite the original intent of the legislation, the Para 7 Sch 20 provisions can have wider implications. One example is where a policy providing benefits on death or earlier critical illness (CI) is made subject to a trust under which the settlor retains the right to the CI benefits. Unless the payment of CI benefits ends the policy or the death benefits remain unreduced, the trust could be treated as giving rise to a reservation of benefit. The facts of each case are important.



### **Pre-owned assets**

In 2004 a new income tax charge, called POAT was introduced to combat certain IHT avoidance schemes where assets are disposed of, but the previous owner continues to enjoy benefit without the gift being caught by the gift with reservation provisions.

The legislation is in Schedule 15 Finance Act 2004. This imposes an income tax charge on the benefit of a free or low-cost enjoyment of a previously owned "substantial capital" asset (or an asset that had been accrued with funds provided by the person who then enjoyed a benefit) where the gift with reservation rules do not apply.

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