

Mr Chancellor of the Exchequer

**NEW CLAUSE 7 INHERITANCE TAX: GIFTS WITH
RESERVATION**

To move the following Clause-

‘(1) Section 102 of the Finance Act 1986 (c. 41) (gifts with reservation) is amended as follows.

(2) In subsection (5) (section not to apply where disposal is an exempt transfer by virtue of any of the provisions of the Inheritance Tax Act 1984 specified in the paragraphs of that subsection) at the end of paragraph (a) (section 18: transfers between spouses) insert “, except as provided by subsections (5A) and (5B) below.”

(3) After subsection (5) insert-

“(5A) Subsection (5)(a) above does not prevent this section from applying if or, as the case may be, to the extent that -

(a) the property becomes settled property by virtue of the gift,

(b) by reason of the donor’s spouse (“the relevant beneficiary”) becoming beneficially entitled to an interest in possession in the settled property, the disposal is or, as the case may be, is to any extent an exempt transfer by virtue of section 18 of the 1984 Act in consequence of the operation of section 49 of that Act (treatment of interests in possession),

(c) at some time after the disposal, but before the death of the donor, the relevant beneficiary’s interest in possession comes to an end, and

(d) on the occasion on which that interest comes to an end, the relevant beneficiary does not become beneficially entitled to the settled property or to another interest in possession in the settled property.

(5B) If or, as the case may be, to the extent that this section applies by virtue of subsection (5A) above, it has effect as if the disposal by way of gift had been made immediately after the relevant beneficiary’s interest in possession came to an end.

(5C) For the purposes of subsections (5A) and (5B) above-

(a) section 51(1)(b) of the 1984 Act (disposal of interest in possession treated as coming to end of interest) applies as it applies for the purposes of Chapter 2 of Part 3 of that Act; and

(b) references to any property or to an interest in any property include references to part of any property or interest.”.

(4) The amendments made by this section have effect in relation to disposals made on or after 20th June 2003.’.

EXPLANATORY NOTE:

SUMMARY

1. This clause introduces changes to the inheritance tax (IHT) provisions for lifetime gifts in section 102 Finance Act 1986 where the person making the gift (donor) reserves or receives any material benefit in relation to the gifted asset. This is often referred to as a “gift with reservation.” In its recent decision in the case of CIR v Eversden the Court of Appeal held that these special rules do not currently apply when gifts by a married person are made through a trust which initially gives an interest in possession to their spouse.
2. The existing provisions in section 102 Finance Act 1986 are amended so that the normal “gift with reservation” charge will apply to gifts made on or after 20 June 2003 where:
 - the gift is made into trust and the donor’s spouse enjoys an interest in possession;
 - the interest in possession comes to an end (whether on the donee’s death or otherwise); and
 - the subsequent use of the gift is such that it would count as a taxable “gift with reservation” if the gift had been made at the time the interest in possession comes to an end.

DETAILS OF THE CLAUSE

3. Subsection (1) is introductory and provides for the amendments which follow to be made to section 102 Finance Act 1986.

4. Subsection (2) amends section 102(5)(a) to disapply the current exception from section 102 for gifts to a spouse in circumstances which come within new sections 102(5A) and (5B).
5. Subsection (3) inserts three new subsections into section 102(5).
6. New section 102(5A) disapplies the current exception from section 102 Finance Act 1986 for gifts to a spouse where gifts are made, and
 - 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 because 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 comes to an end;
 - when that interest in possession comes to an end, the beneficiary does not become beneficially entitled either to the settled property, or to another interest in possession in it.
7. New section 102(5B) provides for section 102 to have effect in these circumstances as if the gift had been made immediately after the relevant beneficiary's interest in possession ends (so that it is only the circumstances after that date which determine whether the property is "subject to a reservation", even if the donor dies within seven years).
8. New section 102(5C) imports the rule at section 51(b) of the Inheritance Tax Act 1984 treating an interest in possession as coming to an end when it is disposed of, and makes clear that references to property or an interest in property includes part of any property or interest.
9. Subsection (4) applies the new provisions to gifts made on or after 20 June 2003.

BACKGROUND NOTE

10. Gifts made in a donor's lifetime are in general "potentially exempt transfers" (PETs): that is, they are exempt from IHT so long as the donor survives the gift by at least seven years. Finance Act 1986

(section 102 and Schedule 20) contains special rules on the taxation of lifetime gifts where the donor reserves or receives any material benefit in relation to the gifted asset. These ‘gifts with reservation’ (GWR) rules are intended to prevent the avoidance of the IHT charge on death through PETs which reduce the value of the donor’s death estate, while leaving the donor to continue enjoying the asset concerned much as they did before the gift.

11. For the purposes of the IHT charge on death, a gift subject to a reservation is effectively treated as made at the time when the benefit available to the donor ceases. If the benefit is available at the time of the donor’s death, the gifted asset is treated as still being part of the donor’s estate on death. Where the benefit ceases during the donor’s lifetime, they are treated as having made a PET at that time of an amount equal to the then value of the gifted asset. But there is an exception to these GWR charges where the gift is made in specific circumstances or to specific beneficiaries, including the donor’s spouse. Litigation in the case of “Eversden” recently decided against the Inland Revenue in the Court of Appeal. This raised the question how far the exception for gifts to a spouse applied to a case where a gift was made into trust, initially giving an “interest in possession” in favour of the donor’s spouse, but where this interest came to an end leaving a continuing reservation in favour of the donor. The Court decided that such a gift is wholly excluded from the GWR rules, while acknowledging that this left significant scope for IHT avoidance through artificial schemes.
12. For example, a trust can be set up by lifetime gifts of property which the donor in fact intends (and needs) to use for the rest of their life; the trust initially gives an interest in possession to the donor’s spouse, but on terms that this can be terminated, or will end automatically, after a brief period; and the property is then held on discretionary trusts for a class of beneficiaries including the donor. The trustees would typically allow the donor the dominant and possibly exclusive benefit from the trust property so long as they are alive and require it: but under the law as the Court of Appeal has found it the property would be entirely removed from the donor’s taxable estate.
13. Ministers are aware of significant activity marketing schemes seeking to exploit this weakness and have introduced this new clause to curtail further loss to the Exchequer.