



Inheritance tax avoidance

Draft legislation and Explanatory Note
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Introduction

As announced in today's Pre-Budget Report legislation will be introduced in Finance Bill 2010 to counter tax avoidance schemes that have been designed to avoid inheritance tax charges on property in trusts.

This document provides the draft legislation and explanatory notes in relation to the changes announced today.

Chapter 1

This section contains the current draft of the legislation.

Inheritance tax

1 Interests in possession

- (1) IHTA 1984 is amended as follows.
- (2) In section 3A (potentially exempt transfers) –
 - (a) in subsection (6), omit “other than section 52”, and
 - (b) after that subsection insert –

“(6A) The reference in subsection (6) above to any provision of this Act does not include section 52 below except where the transfer of value treated as made by that section is one treated as made on the coming to an end of an interest which falls within section 5(1B) above.”
- (3) In section 5 (meaning of estate) –
 - (a) in subsection (1)(a)(ii), after “below” insert “unless it falls within subsection (1B) below”, and
 - (b) after subsection (1A) insert –

“(1B) An interest in possession falls within this subsection if the person –
 - (a) was domiciled in the United Kingdom on becoming beneficially entitled to it, and
 - (b) became beneficially entitled to it by virtue of a disposition which was prevented from being a transfer of value by section 10 below.”
- (4) In –
 - (a) section 49(1A) (treatment of interests in possession),
 - (b) section 51(1A) (disposal of interest in possession), and
 - (c) section 52(2A) and (3A) (charge on termination of interest in possession),insert at the end (not as part of paragraph (c)) –

“or falls within section 5(1B).”
- (5) In section 57A(1A) (relief where property enters maintenance fund), insert at the end (not as part of paragraph (c)) –

“or fell within section 5(1B).”
- (6) In section 100(1A) (alterations of capital etc where participators are trustees), insert at the end (not as part of paragraph (c)) –

“or falls within section 5(1B).”
- (7) In section 101(1A) (companies’ interests in settled property), insert at the end

(not as part of paragraph (b)) –
“or falls within section 5(1B).”

- (8) In section 102(ZA)(1)(b)(ii) of FA 1986 (gifts with reservation: termination of interests in possession), after “serial interest” insert “or falls within section 5(1B) of the 1984 Act”.
- (9) In F(No.2)A 1987, omit section 96(2)(c).
- (10) The amendments made by this section have effect in relation to an interest in possession to which a person is beneficially entitled if the person becomes beneficially entitled to it on or after 9 December 2009.

2 Reversionary interests of purchaser or settlor etc in relevant property

- (1) In IHTA 1984, after section 81 insert –

“81A Reversionary interests in relevant property

- (1) Where a reversionary interest in relevant property to which –
 - (a) a person who acquired it for a consideration in money or money’s worth, or
 - (b) the settlor or the spouse or civil partner of the settlor, (a “relevant reversioner”) is beneficially entitled comes to an end by reason of the relevant reversioner becoming entitled to an interest in possession in the relevant property, the relevant reversioner is to be treated as having made a disposition of the reversionary interest at that time.
 - (2) A transfer of value of a reversionary interest in relevant property to which a relevant reversioner is beneficially entitled is to be taken to be a transfer which is not a potentially exempt transfer.”
- (2) The amendment made by subsection (1) has effect in relation to reversionary interests to which a relevant reversioner becomes beneficially entitled on or after 9 December 2009.

Chapter 2

This section contains the draft Explanatory Notes based on the current draft of the legislation.

CLAUSE [1]: INHERITANCE TAX

SUMMARY

1. Clause [1] provides that where an interest in a trust is purchased then for inheritance tax (IHT) purposes it will be treated as part of the purchaser's estate.

DETAILS OF THE CLAUSE

2. Subsection (1) provides that the Inheritance Tax Act 1984 (IHTA) is amended as follows.
3. Subsection (2) amends section 3A of IHTA, which provides for certain transfers to individuals to be potentially exempt from IHT.
4. Subsection (2)(a) removes the reference to a charge under section 52 of IHTA being treated as a potentially exempt transfer. (Section 52 of IHTA provides for there to be an IHT charge where an interest in a settlement that is treated as part of a person's estate comes to an end.)
5. Subsection (2)(b) inserts new subsection (6A) into section 3A of IHTA. This reinstates the position that a transfer of value under section 52 will be potentially exempt, but provides for an exception to this where the section 52 charge arises in respect of an interest that is treated as part of a person's estate under new section 5(1B) of IHTA. This means that, for example, where the trust comes to an end and the capital is paid out, the transfer of value will be immediately chargeable to IHT.
6. Subsection (3) amends section 5(1)(a)(ii) of IHTA so that interest in possessions defined in new subsection (1B) of section 5 of IHTA will be excluded from the general provision that interest in possessions are not treated as part of a person's estate.
7. Subsection (3)(b) inserts new subsection (1B) into section 5 of IHTA, so that it includes a new category of interest in possessions that will be included as part of a person's estate. These are interests to which a UK domiciled person is entitled and that the person acquired that interest in an arm's length transaction (as defined in section 10 of IHTA).

8. Subsection (4) provides for consequential amendments to other provisions so that they include interests in possession as defined in new section 5(1B) of IHTA.
9. Subsection (4)(a) provides that the person who has a section 5(1B) interest will be treated as being beneficially entitled to the property underlying that interest by virtue of section 49(1A) of IHTA. This means that, for example, on death, they will be treated as if they owned the property in which their interest subsisted.
10. Subsection (4)(b) amends section 51(1A) of IHTA, which provides that where a person disposes of an interest in possession it is not a transfer of value, but IHT charges may arise under section 52 of IHTA. This provision applies only to certain categories of interest in possession, which are extended to include section 5(1B) interests.
11. Subsection (4)(c) amends section 52(2A) and (3A) of IHTA which provide for IHT charges when an interest in possession comes to an end during the beneficiary's lifetime. The charges only apply to certain interests in possession; these are extended to include section 5(1B) interests. This means, for example, that if a person gives their interest away or their interest comes to an end, then there is an IHT chargeable event.
12. Subsection (5) amends section 57A(1A) of IHTA, which provides for relief where an interest in possession is included as part of a person's IHT estate if within two years of their death the property in which they had their interest becomes held in a trust that has been approved as a heritage maintenance fund. The relief is extended to interest in possessions that will be treated as part of a person's estate under section 5(1B).
13. Subsection (6) amends section 100(1A) of IHTA, which deems there to be a disposition for IHT purposes if there is a change in a close company's share capital (where an individual is entitled to certain categories of interests in possession.). This is extended to interests in possession that will be treated as part of a person's estate under section 5(1B).
14. Subsection (7) amends section 101(1A) of IHTA, which treats the participators of a close company as being entitled to an interest in possession in any settled property held by the company. This applies only to certain categories of interest in possession, which are extended to interests that will be treated as part of a person's estate under section 5(1B).
15. Subsection (8) amends section 102ZA(1)(b)(ii) of the Finance Act 1986. This provides for the gifts with reservation rules to apply to a person with certain categories of interest in possession, which are extended to include interests that will be treated as part of a person's estate under section 5(1B).
16. Subsection (9) is a consequential amendment as a result of the changes in section 1(2).

17. Subsection (10) provides that these amendments will have effect only for interests in possession to which a person becomes entitled on or after 9 December 2009.

BACKGROUND NOTE

18. An interest in possession is an interest in which a beneficiary has the right to any income arising on the property in a trust. Changes made to the trust rules in 2006 mean that most interest in possessions are now included in the relevant property regime. Broadly, IHT charges arise on relevant property:
- ⌚ at 20 per cent on assets put into trust which exceed the IHT nil-rate band (with a further charge of up to 20 per cent if the person dies within seven years of making the transfer);
 - ⌚ at 6 per cent every ten years on the value of the trust assets over the nil-rate band (the ‘periodic charge’); and
 - ⌚ an ‘exit charge’ when funds are taken out of trust between ten-year anniversaries at a rate based on the time since the last ‘periodic charge’.
19. HM Revenue & Customs (HMRC) became aware of arrangements that sought to avoid any IHT charges on assets that are put into a trust. The arrangement was designed to allow individuals who would normally be chargeable to IHT on transfers in to trust to purchase an interest in a trust that had not been subject to UK IHT charges when property had originally been transferred in to it.
20. The clause provides that where an interest has been purchased at full value then that interest will be treated as part of a person’s estate. Where a person puts funds in to a trust in the normal course of events the normal IHT charges will apply, and the changes in new section 5(1B) will not apply. If a person purchases an interest in a trust other than at arms length then section 10 of IHTA will not apply and there will be a transfer of value in the normal way.
21. Where new section 5(1B) applies to treat the interest as part of a person’s estate the property in the trust will still be part of the relevant property regime.
22. Some interests in possession are already treated as part of a person’s estate – for example, a disabled person’s interest. This clause does not affect any such interests.

CLAUSE [2]: INHERITANCE TAX

SUMMARY

23. Clause [2] provides that where a person transfers property into a trust in which they or their spouse or civil partner retains a future interest, or where a person purchases a future interest in a trust, then there will be inheritance tax (IHT) charges when that future interest comes to an end and they take their actual interest.

DETAILS OF THE CLAUSE

24. Subsection (1) inserts new section 81A into the Inheritance Tax Act 1984 (IHTA):
- ⌚ New section 81A(1) provides for there to be a disposition for IHT purposes where a reversionary interest in relevant property comes to an end and the person takes the actual interest where that person:
 - purchased the reversionary interest; or
 - where the person who is entitled to the reversionary interest is the settlor or the spouse or civil partner of the settlor of the trust.
 - ⌚ New section 81A(2) provides that where a reversionary interest defined in new section 81A(1) is given away it will not be a potentially exempt transfer.
25. Subsection (2) provides for these changes to have effect for reversionary interests to which a person has become entitled in the circumstances specified in new section 81A on or after 9 December 2009.

BACKGROUND NOTE

26. A reversionary interest is a future interest in a trust as defined in section 47 of IHTA. Reversionary interests are not generally treated as part of a person's IHT estate, but section 48(1) of IHTA provides for certain exceptions to that rule.
27. IHT charges arise on relevant property:
- ⌚ at 20 per cent on assets put into trust which exceed the IHT nil-rate band (with a further charge of up to 20 per cent if the person dies within seven years of making the transfer);
 - ⌚ at 6 per cent every ten years on the value of the trust assets over the nil-rate band (the 'periodic charge'); and
 - ⌚ an 'exit charge' when funds are taken out of trust between ten-year anniversaries at a rate based on the time since the last 'periodic charge'.

28. HM Revenue & Customs (HMRC) became aware of arrangements that sought to avoid any IHT charges on assets that are put into a trust. The arrangement was designed to exploit the rules that treat certain reversionary interests as part of a person's estate in order to reduce the entry charge where assets are put in to trust.
29. This clause provides that where certain reversionary interests that are treated as part of a person's estate come to an end and that person takes their actual interest in the relevant property trust then there is a deemed disposition for IHT purposes. This means that there is a transfer of value and IHT will be charged based on the value of the reversionary interest immediately before it came to an end. To prevent these charges being avoided by a person gifting their reversionary interest to another person, such a transfer will be an immediately chargeable IHT event.
30. These changes affect only reversionary interests in relevant property. They do not affect certain interests in possession which are not included as part of the relevant property regime (for example, a disabled person's interest).