TAXREP 34/01

INHERITANCE TAX

Text of a memorandum submitted in November to the Paymaster General by the Tax Faculty of the Institute of Chartered Accountants in England and Wales, the Chartered Institute of Taxation, the Law Society of England and Wales, the Law Society of Scotland and the Society of Trust and Estate Practitioners

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INTRODUCTION

1. We are writing to you on behalf of the Chartered Institute of Taxation, the Institute of Chartered Accountants in England and Wales, the Law Society of England and Wales, the Law Society of Scotland and the Society of Trust and Estate Practitioners. We are very concerned by two issues which could have serious consequences for the perception of the UK as an attractive place for non-UK domiciliaries to live.

IMPACT OF DECISION IN *IRC V. MELVILLE*

2. As you will be aware, the Court of Appeal recently upheld the High Court's decision in favour of the taxpayer in the case of *IRC v. Melville*. The case involved a capital gains tax avoidance scheme which depended for its efficacy on an argument that a retained interest constituted a right (for inheritance tax purposes) which had significant value in the taxpayer's estate. Until that decision, it had been generally accepted by the Inland Revenue that trust assets were taxed under a separate regime which varied depending (in most cases) on whether the trust had a qualifying interest in possession or not. This regime was clear and logical and ensured that trust assets would be taxable at appropriate intervals while avoiding double taxation of the same assets.

3. Consistently with its understanding and practice since the introduction of capital transfer tax in 1974, it was the Inland Revenue who argued in *Melville* against the interpretation of the inheritance tax legislation giving rise to the prospect of double taxation with which this letter is concerned.

4. As a result of the *Melville* decision the logical structure of inheritance tax is seriously damaged, and there is considerable scope for double taxation. The Inland Revenue already enjoys more than adequate power to deal with any case where a person retains an interest in settled property as a result of the introduction of the "gift with reservation" regime by the Finance Act 1986. Under those provisions, a settlor retaining any interest at all under a discretionary settlement is treated as having retained the trust property within his estate. There has never been any doubt but that a power of revocation constitutes a retained interest for the purposes of the 1986 Act. It is entirely unnecessary, as well as illogical, to treat the power of revocation as being an asset comprised in the settlor's estate under *Melville* as well.

5. The previously-understood position for inheritance tax purposes coincided with that for capital gains tax, which is that a disposition into a revocable settlement is nevertheless a complete disposition for the purposes of that tax (s.70 TCGA 1992), there never having been the remotest suggestion since the introduction of capital gains tax in 1965 that a power of revocation was an asset for capital gains tax purposes, the release of which was a disposal for the purposes of that tax, so giving rise to the prospect of a double charge to capital gains tax.

6. The *Melville* decision has several serious consequences, both for the Inland Revenue and for the taxpayer, particularly certain categories of taxpayer.

7. Reversal of the *Melville* decision would of itself preclude future capital gains tax avoidance schemes along the lines of that used in the *Melville* case.

8. As indicated above, the logical structure of inheritance tax is seriously damaged and there is considerable scope for double taxation. A brief memorandum is attached to this letter which illustrates some of the possible consequences (see Annex).

9. Non-UK domiciliaries frequently hold a substantial part of their assets through trusts. It is common for these trusts to include general powers of appointment or a power of revocation exercisable by the settlor. Such trusts (known in the USA as living revocable trusts) are particularly common for US citizens. They are entirely tax neutral in the USA but simplify the administration of the settlor's estate after his death by reducing the assets which are subject to the probate process which tends, in the USA, to be both cumbersome and expensive.

10. As you will appreciate, UK situated property is within the charge to inheritance tax irrespective of the domicile of the owner of the asset. Because, *Melville* apart, neither English nor Scottish law has a concept of a power as property, there is no developed private international law as to the *situs* of such a power. There is a possibility that a non-UK domiciliary who dies whilst temporarily resident in (or even whilst on a visit to) the UK will thereby have all of the non-UK trust property previously settled by him on trusts having no connection with the UK brought into charge to inheritance tax.

11. There are of course a significant number of US citizens living and working in the UK who have made use of living revocable trusts. While it is not possible to predict the consequences should no action be taken to reverse the effect of the *Melville* decision, one can confidently say that one consequence would be to make the UK a significantly less attractive place for US citizens to live and work (even for short periods) and that this would in turn have an adverse effect on the place of the City of London as an international financial centre. Other international centres such as the UK's oil capital, Aberdeen, would also suffer.

12. In addition, there are a number of UK domiciled individuals who also hold US citizenship. These individuals, who may have no intention of leaving the UK, will be subject to both UK inheritance tax and US estate duty on their worldwide assets. As with other US citizens, they may well have put their US assets into a revocable trust to avoid the cumbersome US probate procedures. The impact of the *Melville* decision on these individuals will be to expose them to a double charge to inheritance tax – once on the value of the assets in the revocable trust and once on the lapsing of the power of appointment on their death. Such double taxation is inequitable.

13. There are other instances where powers of revocation or general powers of appointment have been used. In particular, individuals coming to the UK from civil law jurisdictions, such as Continental Europe, may have put assets into a civil law foundation, their equivalent of a trust. These often involve the reservation of rights to the founder, which could also be affected by the decision in the *Melville* case.

14. A decision to reverse the impact of the *Melville* decision so as to restore the inheritance tax position to what it was generally believed to be prior to the decision would, we believe, be welcomed both by the Inland Revenue and also by the body of taxpayers. It would preclude further use of the *Melville* scheme and at the same time would prevent assets being brought within the charge to inheritance tax which it is clear from the overall structure of the inheritance tax legislation were never intended to be brought into charge.

15. We were also asked by senior officials at Inland Revenue, Capital Taxes to comment on the potential wider economic impacts of the case. We believe that a failure to reverse the impact of this decision could lead to a number of non-UK domiciled individuals considering whether to leave the UK, (including a large number of US citizens working in the City of London). In addition there would be a loss of invisible earnings amongst businesses serving such clients and who are involved in the creation of English or Scottish law trusts for a considerable number of individuals from jurisdictions including Europe, South America and the Middle East who, whilst not resident here, wish to make use of English or Scottish law trusts or English or Scottish resident trustees. We are aware of specific instances where work has been lost to New Zealand and canvassed views on 29 November 2001 from the International Committee of STEP whose members are drawn from leading offshore centres. They were unanimous in indicating that the uncertainty created by *Melville* was a real disincentive to using UK based trustees as fiduciaries for international families.

EXCLUDED PROPERTY TRUSTS

16. In discussions with senior officials within the Revenue we were asked to give our views on another issue affecting non UK domiciled settlors. This concerns the interaction of the inheritance tax rules on excluded property trusts and gifts with a reservation of benefit. In 1986, the Inland Revenue stated (and allowed to be published) their view that the excluded property provisions overrode the reservation of benefit provisions; and this view was until recently confirmed in the relevant published Manual. We understand that the Inland Revenue have recently received advice that this view is incorrect in relation to settlements where the settlor did not reserve an initial interest in possession, and the confirmation in the Manual has been removed. The earlier view enabled non-UK domiciled individuals to shelter their non-UK assets from inheritance tax by transferring these assets into a trust. This possibility had been an inherent part of the taxing regime since the introduction of capital transfer tax in 1974. While the gift with reservation provisions were necessary to prevent abuse of the rules introduced in 1986 which allowed certain lifetime gifts to be made free of inheritance tax, the same rationale did not apply to non-UK assets belonging to non-UK domiciled individuals which had always been freely transferable without capital transfer tax consequences. The Inland Revenue ruling on the interaction of the excluded property and gifts with reservation rules therefore seemed entirely logical and consistent with the originally-intended scope of capital transfer tax as it applied to non-domiciled individuals.

17. In the experience of many of our members, this has been a fundamental part of the tax regime which the UK offers to non-UK domiciliaries and which has made the UK an attractive place for these individuals. Our members have found that clients are very concerned that protracted residence in the UK (which can make these individuals deemed domiciled in the UK for inheritance tax purposes although not actually domiciled here for other fiscal purposes) should not expose their worldwide assets to inheritance tax. The deemed domicile rules depend on residence for income tax purposes which can be acquired by a person spending an average of three months in the UK over a period of years. There are many "international" families who divide their time between a number of homes and who may be treated as resident in the UK under these rules but who clearly have no intention of making their real home in the UK so as to acquire an actual domicile.

18. We believe that if the Inland Revenue do decide to retract their previously-published view on the interaction of the excluded property and reservation of benefit provisions, many of these individuals will leave the UK for regimes which will not subject their assets to inheritance or similar taxes. This is likely to have a significant economic impact on the South East of England in particular and especially London where many non-UK domiciliaries have their UK base. It would also have an impact on other areas, for example the market for Scottish estate property. Retaining the current position would allow the UK to continue to attract wealthy individuals to live here, with the ensuing economic benefits, in terms of employment and the payment of both consumer taxes (such as VAT and Stamp Duty) and the corresponding increase in tax on business profits.

19. If it is decided that the new Inland Revenue view should be adopted, then we believe that it is only equitable that individuals who have already created structures in reliance (explicit or not) on the Revenue's published view should not be prejudiced and that existing structures should be unaffected by the change of view. We would therefore urge you to introduce "grandfathering" provisions which would allow non-UK assets in existing structures to continue to be treated as excluded property for inheritance tax purposes even if the settlor of the trust who remained a beneficiary should subsequently become (or have already become since creating the trust) UK domiciled or deemed domiciled for inheritance tax purposes.

20. The individuals likely to be most affected by these changes are wealthy international families who have houses around the world and spend only a few months in the UK each year. A change to the inheritance tax rules, because the tax is based on the value of assets, rather than just the income or realised gains is likely to be regarded as particularly unpalatable by these individuals. As indicated above, these individuals are normally highly mobile and will therefore be able and more likely to leave the UK quite rapidly if they consider the UK tax regime to have become unfavourable. We do not believe that this result would be in the long term interests of the UK.

21. Finally, the uncertainty over the interaction of the excluded property and reservation of benefit rules reflects the unsatisfactory nature of the existing legislation. We believe that the importance of the matter is such that if any change is to be made, it should be made not by a mere announcement of a change of view by the Inland Revenue but by a clear and unambiguous amendment to the legislation after proper consideration of all of the issues by Parliament.

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ANNEX

EXAMPLES OF DOUBLE TAXATION CAUSED BY *MELVILLE* DECISION

1. X (a US citizen and resident) creates a living revocable trust to hold his US assets. He is then posted to London and dies two years later, leaving a brother but no spouse or children. If the power of revocation is regarded as situated in the UK, the entire value of his US assets would be fully taxable in the UK even though the assets themselves are excluded property. It is not clear that there would be any credit in the UK for the US tax payable on the assets in the trust nor vice versa. It is also far from clear that the US / UK Double Tax Treaty would prevent a UK tax charge, especially if X had been resident in the UK for 3 years or more.

2. X created a life interest trust on himself and retains a power of revocation. He wishes to release his life interest in favour of his children. If he retains the power of revocation, his estate will continue to comprise an asset the value of which will be equal to the value of the trust assets. At the same time, his children's estate will also include the entire value of the trust assets. The value of these assets will therefore be fully taxable both on the death of X and on the death of his children with no allowance for the double taxation.

    a. If X wishes to release his power of revocation, the value of his estate will have decreased by the value of the right (i.e. the full value of the trust assets). He will therefore have made a chargeable transfer of this amount which will be fully chargeable since it cannot come within IHTA s.3A(2) (which requires the value of the transfer to become comprised in another individuals' estate). The value of the trust assets will be unchanged as will the value of his children's estates.

    b. If X wishes to release his power of revocation before releasing his life interest, he has a different problem. Arguably his estate comprises two assets, the interest in possession (worth £x) and the power of revocation (also worth £x). His estate is therefore worth £2x even though the trust assets are only worth £x. If he releases the power of revocation, the value of his estate falls by £x (which will constitute a chargeable transfer) and it is then worth only £x, i.e. the full value of the trust and the amount with which he started.

3. Example 2 may not be a real problem if it is correct to say that a power of revocation over property in which one has an interest in possession cannot increase the value of one's estate for inheritance tax purposes. It is at best uncertain whether this analysis is correct. If the trust were to be a discretionary trust, the consequences outlined in Example 2 would unquestionably follow.

4. Y is a UK domiciliary born here and who has lived all his life here. He is also a US citizen, as his mother was American. He creates a living revocable trust, in which he has a life interest, to hold his US assets. On his death, the value of

the assets in the trust are subject to both US estate duty and UK inheritance tax (subject to double taxation relief). However, there is a further charge to inheritance tax on the lapsing of the power of revocation which will be calculated on the value of the assets in the trust. Thus there is a double charge to inheritance tax on Y's death.