

# The British Capital Transfer Tax\*

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## INTRODUCTION

The last major reform in the United States estate and gift tax system occurred in 1954. The system still needs further reform. Although the Tax Reform Act of 1969 originally was intended to reach the estate and gift tax area, the reform effort expired.<sup>1</sup> The political focus of reform is less powerful in the estate and gift tax area than in that of income and social security taxes because most Americans do not leave a taxable estate or even need to file estate returns.<sup>2</sup> The motivation to reduce estate and gift tax is not as broadly based as the motivation to reduce income tax. Even the wealthy have little motivation to push for reform. The present system, although it might theoretically tax at a confiscatory rate of

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1. *Hearings on Tax Reform Before the House Comm. on Ways & Means*, 91st Cong., 1st Sess., pt. 11, at 3969-4185 (1969).

2. COMM. OF INT. REV., ANNUAL REPORT 96,000.

seventy-seven percent, is replete with avenues which lead to a much reduced actual tax rate. Lifetime gifts are a common and effective means of reducing the actual tax effect of a capital transfer, and the wealthy normally have the economic flexibility to use lifetime transfers advantageously. There has been some movement for reform, however, promoted largely by farmers who lack the economic flexibility to avoid the high estate tax rates by proper lifetime transfers.<sup>3</sup>

A five-year study of estate and gift tax was made by the American Law Institute (ALI) in preparation for the Tax Reform Act of 1969:<sup>4</sup> Many of the recommendations<sup>5</sup> of the report were adopted by the Treasury Department in their proposals to the House Ways and Means Committee. The ALI Report and the treasury proposal concerned four major areas of reform: the unification of the estate and gift tax; the one-hundred percent marital deduction; the taxation of generation-skipping transfers; and the taxation of capital appreciation at death. To date, none of these proposals has been incorporated into the estate and gift tax system. This article is intended to explain the recent tax reform in Britain<sup>6</sup> which sweepingly revised prior British estate tax. Because the new British capital transfer tax adopts provisions similar to those of the ALI Report and the Treasury proposals, the British experience could be valuable to the reform of the United States estate and gift tax system.

The first major proposal, a unified transfer tax system, is similar to the unified British capital transfer tax.<sup>7</sup> The British estate tax has been replaced by a single system which taxes both *inter vivos* and death time transfers. The unified tax system reduces the distortion which results from taxing gifts and estates under different systems. In contrast, the United States has a dual system, and the difference between the tax on *inter vivos* and estate transfers is great. Basically, the difference results from three main factors: First, the gift tax rate is only seventy-five percent of the estate tax rate.<sup>8</sup> At any level of transfer, twenty-five percent of the tax is saved by making an *inter vivos* as opposed to an estate transfer.

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3. Wall Street Journal, March 8, 1976, at 1, col. 3.

4. ALI, FEDERAL ESTATE AND GIFT TAX PROJECT (1968) [hereinafter cited as ALI PROJECT].

5. ALI RECOMMENDATIONS ON ESTATE AND GIFT TAXATION (1969).

6. Finance Act of 1975 [hereinafter cited as F.A.].

7. Proposal 6, Treasury Dep't, cited in HOUSE COMM. ON WAYS & MEANS & SENATE COMM. ON FINANCE, TAX REFORM STUDIES & PROPOSALS, 91st Cong., 1st Sess. (1969) [hereinafter cited as Treas. Proposal]; Pierson, *Death & Taxes: Bids to Ease Burden of Estate, Gift Levies Likely to Stir Dispute*, Wall Street J., Apr. 27, 1976, at 1, col. 6 (Pac. ed.).

8. INT. REV. CODE OF 1954, §§ 2001, 2502.

Second, the gift tax provides for independent aggregation of transfers. Transfers under the estate and gift tax system are taxed at progressive rates, and the dual tax system can be used as a means of splitting transfers. The gift tax also provides an annual exclusion and a \$30,000 lifetime exemption. The third factor which favors lifetime transfers over death transfers is that the estate and gift tax have different tax bases. The estate tax is based on the gross transfer or gross estate without reduction for the tax liability,<sup>9</sup> whereas the gift tax is based on the net transfer.<sup>10</sup> The difference in tax bases, which can result in considerable tax savings, arises from different rules regarding liability for the estate and gift taxes.<sup>11</sup> The transferor is liable for all gift taxes, and therefore the payment of the tax does not itself constitute an additional gift. In comparison, a decedent's property is transferred to his estate, which is liable for the tax. Thus, the estate tax is imposed on the entire estate, including the value of the property used to pay the tax itself.

The savings in taxes can be seen in the following example: If a decedent leaves an estate of \$10,000,000 to a child, the estate tax will be approximately \$6,000,000 and the child will receive a net bequest of about \$4,000,000. If however the same taxpayer decides to make the maximum transfer he could make to the same beneficiary, he would make a lifetime gift of roughly \$6,500,000 and incur a gift tax of about \$3,500,000, thereby consuming all his assets. By transferring property during his lifetime, he would be able, solely because of the difference in the tax base, to increase the net amount given the beneficiary from \$4,000,000 to \$6,500,000, an increase of over sixty percent.<sup>12</sup> It would seem that unless there is a clear policy to support such a distinct treatment of transfers, effort should be made to reduce the distinction and thereby reduce the distortion created by tax consideration.

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9. *Id.*, §§ 2001, 2051.

10. *Id.*, § 2502.

11. *Cf. id.*, §§ 2002, 2501(d).

12. This example applies, for purposes of illustration, estate tax rates to gifts in order to focus solely on this feature of the gift tax. Kurtz & Suckey, *Reform of Death and Gift Taxes: The 1969 Treasury Proposals, The Criticisms, and a Rebuttal*, 70 COLUM. L. REV. 1365 (1970). See also Westfall, *Revitalizing the Federal Estate and Gift Taxes*, 83 HARV. L. REV. 986 (1970) and articles cited at 986 n.2, 987 n.6.

The second major proposal of the ALI,<sup>13</sup> which can also be found in the British transfer tax, is the unlimited marital deduction which permits tax-free transfers between spouses. The tax-free transfer between spouses would not be a radical departure from the present United States estate and gift tax. Normally the optimal distribution of assets between spouses for purposes of further transfer is an equal distribution. The community property states already approximate such splitting of assets, and the marital deduction for transfers at death and *inter vivos* also permits splitting of assets.<sup>14</sup> Thus much of the benefit of tax-free inter-spousal transfers is already available. The proposal to permit tax-free transfers would, however, greatly simplify estate and gift tax considerations and remove the remaining inequities between separate and community property states in inter-spousal transfers.

The third major proposal of the ALI is the taxation of generation-skipping trusts. This proposal would at least partially effectuate the policy of taxing capital once a generation.<sup>15</sup> Present estate and gift tax law permits skipping a generation either by direct transfer to a member of a remote generation or by establishment of a trust with a series of life estates. Generation-skipping trusts allow the enjoyment of the property by each generation of beneficiaries but avoid the taxation as the enjoyment passes from one generation to the next.<sup>16</sup> The Internal Revenue Service proposed that the Tax Reform Act of 1969 include a tax on generation-skipping transfers. The proposed tax was designed so that no tax savings would accrue from generation-skipping transfers, which were defined as transfers to a relative more than one degree in family relationship below the donor. The British transfer tax system also provides that capital should be taxed once a generation; this is accomplished under the British system by taxing the termination of an interest in possession. A life income beneficiary of a trust is treated as the beneficial owner of the trust corpus supporting his interest for transfer tax purposes so that at a life tenant's death the corpus supporting his interest is aggregated in his estate.<sup>17</sup> Trusts where there is no fixed interest, such as discretionary trusts, are taxed every ten years at thirty percent of the ordinary rate. Outright transfers to members of a remote generation are taxed at the ordinary rate.

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13. ALI PROJECT 36.

14. INT. REV. CODE OF 1954, §§ 2056, 2513, 2523.

15. ALI PROJECT 25.

16. Treas. Proposal 31.

17. Cf. INT. REV. CODE OF 1954, § 2036, which taxes property supporting a retained life interest.

The fourth major analog is the taxation of capital gains at death. Present tax law provides for a stepped-up basis<sup>18</sup> for property included in the estate, and half the community property gets a stepped-up basis even though it is not included in the decedent's estate. The increased basis permits certain gains to avoid taxation. Under the Treasury proposal<sup>19</sup> appreciation would be taxable, and the gain would be included in the final return of decedent. The result would be similar to the sale of the assets just before death. The British tax system has wavered in its treatment of capital gains on death. They are not taxed at present, but the government has stated its intention to do so in the future.

These major proposals are part of the British tax system and knowledge of the British system could provide insight into the expected changes in the United States estate and gift tax system.

#### THE BRITISH CAPITAL TRANSFER SYSTEM

Until 1974, Britain had no form of gift tax. The fiscal system operated with few, but very severe, taxes, and there were well-known, widely practiced, and widely accepted loopholes at least in the estate duty system—the death tax.

The system of taxing capital was elementary and ineffective. Capital gains taxation was not introduced until 1965. Estate duty was the only tax on capital, and this was easily avoided by putting property into a trust. The corpus supporting a life interest was aggregated with the gross estate of the life tenant for estate duty purposes, but until 1969 this result was avoidable by creating a discretionary trust rather than a fixed interest trust. In 1969 liability for estate duty upon the deaths of beneficiaries under a discretionary trust was introduced by imposing a charge upon the death of any beneficiary who had received payments of income in (generally) the past seven years.<sup>20</sup> The charge was on a portion of the capital equivalent to the share of income received by the deceased during the period.<sup>21</sup> There was insufficient time to test the effectiveness of this system, which in any case would have failed because the trustees of a discretionary trust could pay the income to those

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18. *Id.*, § 1014.

19. Treas. Proposal 3.

20. F.A. 1969, c. 32, §§ 36, 37, introducing the "substituted." F.A. 1894, 57 & 58 Vict., c. 30, § 2(1)(b).

21. Maudsley, *Tax Planning in England*, 9 SAN DIEGO L. REV. 264, 284 (1972).

whom they judged least likely to die; so long as the income was thus disposed of, there was no objection to making capital payments, which were not taxable, to the old and sick beneficiaries.

Estate duty had therefore done little to equalize wealth. The policy of the Labour Government is to effect a further levelling of wealth, and this will be done in two stages: first, by a capital transfer tax, introduced in 1974; and second, by the Wealth Tax, which is expected in about 1977.<sup>22</sup> Each of these is a new concept to the British. Most European countries have an annual wealth tax, and Britain will soon, no doubt, become accustomed to the wealth tax. The argument is that a person with \$1,000,000 and an income derived from it of (for example \$40,000) is in a stronger economic position than another person who has only the income.<sup>23</sup> This argument must be correct. There is considerable logic in the introduction of a wealth tax, so long as it is used to give relief elsewhere. The fear, however, is that it will be only an additional tax. Whether one likes it or not, it is coming in Britain unless an unforeseen change of Government occurs in the next year or so, but such a change would do no more than delay the wealth tax.

The capital transfer tax imposes a tax on transfers of capital, *inter vivos* or upon death. Originally, the rate was to be the same on each. As finally enacted, however, the system provides for lower rates of tax on *inter vivos* transfers under £300,000 and a higher rate for larger *inter vivos* transfers<sup>24</sup> and transfers made upon death or within three years of death. Estate duty has been abolished. This is not therefore the introduction of a gift tax, but rather a unified system applicable to all capital transfers. It is an attractively simple system, but the calculations are complex. The system is designed to ensure that capital is taxed at least once a generation—not only in the case of a person who keeps his fortune until death, but also in the case of those who, under the estate duty system, could escape the charge by giving away their unneeded millions more than seven years before they died.

### *Taxable Transfers and Transfers of Value*

A taxable transfer is a transfer of value, other than an exempt transfer, made by an individual, after March 26, 1974.<sup>25</sup> A transfer

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22. See White Paper on Capital Transfer Tax, Cmnd. § 705 (1974), and Green Paper on Wealth Tax Cmnd. § 704 (1974). The introduction of the Wealth Tax has been delayed by the failure of the Select Committee of the House of Commons to agree on various details.

23. Chancellor of the Exchequer, *Foreword* to Green Paper on Wealth Tax. See note 22 *supra*.

24. F.A. 1975, c. 7, § 37.

25. *Id.*, § 20(5).

of value occurs when a person makes a disposition, decreasing the net value of his estate.<sup>26</sup> The value transferred is the amount by which the estate is decreased. On death, the deceased is treated as making a transfer of value in the amount of his entire estate immediately before death.<sup>27</sup> It will be seen later that a person beneficially entitled to a possessory estate in trust property is treated as being beneficially entitled to the property in which the interest subsists.<sup>28</sup> Thus, if a life tenant disposes of his interest or if he dies, tax becomes payable on the capital value of the trust. This continues the estate duty rule of taxing the capital value of a trust on a life tenant's death.<sup>29</sup>

A number of exemptions and special situations will be considered below.<sup>30</sup>

### *The Donor's Snowball*

The rates of tax are shown in two tables, the first being applicable to transfers at death or within three years of the transferor's death and the second to lifetime transfers.<sup>31</sup> The rates in the second table are lower, especially with respect to gifts up to £100,000. The system requires the donor to keep a score of his lifetime chargeable gifts, paying the tax on them as it is due. The tax rates are progressive and are applied cumulatively; the rate of tax on a subsequent gift starts at the level reached by the previous gift. The final transfer will be that of the estate on death; and this, like gifts made within three years of death, will be charged under the first table.<sup>32</sup> The final transfer at death is added to the total of *inter vivos* transfers.

The tax on an *inter vivos* gift may be paid by the transferor or the transferee.<sup>33</sup> The calculation of liability would have been much

26. *Id.*, §§ 20(2) (3). It may include an omission to claim an entitlement. *Id.*, § 20(7).

27. *Id.*, § 22.

28. *Id.*, Sched. 5, para. 3(1).

29. There are exceptions in the case of a reverter to the trustor, *id.* § 22(2); and in the case of the trustor's spouse becoming entitled, *id.*, § 22(3).

30. See text accompanying notes 69-114 *infra*.

31. F.A. 1975, c. 7, § 37.

32. *Id.*

33. *Id.*, § 25(2) (a). Any person in whom the property is vested, including trustees and beneficiaries under a settlement, may also be liable if the tax is not paid by the transferor or transferee.

simpler if the transferee were always liable. The imposition of liability on the transferor produces the complication caused by the need to "gross up" the gift. "Grossing up" consists of treating the tax paid as an additional taxable transfer. For example, a gift of £50,000 must be treated as a gift of £54,697, with the transferor paying the tax of £4,697, assuming that this was the transferor's first gift. A further gift of £10,000 becomes £12,334 gross with a tax of £2,334. The donor's lifetime score would then be £67,031. Of course tables exist to compute this tax.<sup>34</sup>

34. F.A. 1975, c. 7, § 37.

FIRST TABLE

Portion of value		Rate of tax
Lower limit £	Upper limit £	Per cent.
0	15,000	Nil
15,000	20,000	10
20,000	25,000	15
25,000	30,000	20
30,000	40,000	25
40,000	50,000	30
50,000	60,000	35
60,000	80,000	40
80,000	100,000	45
100,000	120,000	50
120,000	150,000	55
150,000	500,000	60
500,000	1,000,000	65
1,000,000	2,000,000	70
2,000,000	—	75

SECOND TABLE

Portion of value		Rate of tax
Lower limit £	Upper limit £	Per cent.
0	15,000	Nil
15,000	20,000	5
20,000	25,000	7½
25,000	30,000	10
30,000	40,000	12½
40,000	50,000	15
50,000	60,000	17½
60,000	80,000	20
80,000	100,000	22½
100,000	120,000	27½
120,000	150,000	35
150,000	200,000	42½
200,000	250,000	50
250,000	300,000	55
300,000	500,000	60
500,000	1,000,000	65
1,000,000	2,000,000	70
2,000,000	—	75

The grossing up complication does not arise if the transferee is willing to pay the tax. The first gift would be treated as one of £50,000, on which the transferee would pay a tax of £3,875; the second would be a gift of £10,000, with a tax of £1,750. The transferee, therefore, receives net gifts of smaller amounts. If the transferor then died, the liability of the estate would be based on rates for death transfers starting at that applicable to £67,031 in the first case, and that applicable to £60,000 in the second. Transfers on death are treated as gifts of the gross. The deceased's personal representatives will be liable for the tax on the value of the estate at the appropriate rate.<sup>35</sup> If either gift was within three years of death, an additional payment would be due.<sup>36</sup>

#### TAXATION OF TRUSTS

Trusts raise special problems in connection with the capital transfer tax. Clearly, the creation of an *inter vivos* trust must be treated as a capital transfer. A testamentary trust also constitutes a capital transfer, for a transfer is deemed to have occurred immediately prior to death. But, if that was all, there might be no further transfer during the existence of the trust, which might last throughout the Rule Against Perpetuities period. Where, however, there is a life tenant, it is obvious that the British legislation would provide for a tax on the capital value of the trust upon his death. This would also have been the case under the estate duty system. With discretionary trusts, there is no obvious solution to the problem of taxing the capital of the trust. Tax is charged when the capital is distributed, actually or constructively. The principle of taxation once a generation applies to each. Accordingly, there is a transfer to the trust when it is created, a transfer from the trust when capital is paid out, a transfer of all the capital of the trust when a life tenant dies, and a transfer from the capital of a discretionary trust each tenth year, with tax payable at thirty percent of the amount which would have been payable if the capital had all been paid out. Thus, you pay when you put property into trust, and you pay when you take it out. Special provision is required to determine the rate at which tax is payable on a distribution from a trust. But whose snowball should be used?

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35. F.A. 1975, c. 7, § 25(5)(a).

36. *Id.*, § 25(4). Personal representatives are not liable in respect to *inter vivos* gifts.

### *Trusts Where There is an Interest in Possession*

A person entitled to an interest in possession of trust property is treated for the purposes of capital transfer tax as if he were the beneficial owner of the property.<sup>37</sup> Tax is chargeable on the whole capital value of the trust corpus when the interest in possession comes to an end. This will occur on the death of the person entitled, on the disposal of his interest, on a surrender of the interest, or on its termination in whole or in part by an appointment of the property in which the interest subsisted.<sup>38</sup> Special provisions deal with cases in which there is a shared entitlement to the income,<sup>39</sup> where the beneficiary is entitled to a fixed amount,<sup>40</sup> or in which the beneficiary is entitled to the use and enjoyment of non-income producing property.<sup>41</sup>

The termination of an interest in possession is a transfer of value made by the person beneficially entitled to the interest. Accordingly, the rate of tax chargeable upon the trust property is determined by the circumstances of the person entitled to the interest.<sup>42</sup> It counts, in short, as a gift by him. It may be an *inter vivos* or a testamentary gift, depending on whether the interest comes to an end within three years of death. No grossing up problem exists because in either situation the value of the transfer is not the loss to the transferor but rather the value of the property in which the interest subsisted.

There are five special situations in which there is partial or total relief on termination of an interest. When a trustor has given a life interest with remainder to himself,<sup>43</sup> or when the spouse of the trustor becomes entitled to an interest in possession,<sup>44</sup> no tax is payable. When the person whose interest ends becomes on the same occasion entitled to the property or to another interest in possession in the property, tax is chargeable only to the extent that the value of the property to which he becomes entitled is less than the value of the property in which his interest subsisted.<sup>45</sup> If the person entitled to an interest in possession disposes of his interest for consideration in money or money's worth, tax is chargeable as

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37. *Id.*, Sched. 5, para. 3(1).

38. *Id.*, para. 4(2).

39. *Id.*, para. 3(2).

40. *Id.*, para. 3(3).

41. *Id.*, para. 3(1), (5).

42. *Id.*, para. 4(2).

43. *Id.*, para. 4(5).

44. *Id.*, para. 4(6).

45. *Id.*, paras. 4(4), 10(b).

if he made a gift in the amount of the corpus of the trust less the consideration received.<sup>46</sup> There are provisions for the reduction of the rate of tax when an interest in possession in trust property comes to an end within four years of a chargeable transfer.<sup>47</sup>

#### *Trusts Where There is no Interest in Possession*

The taxation of discretionary trusts is necessarily more complex. The system just described, which is based on the termination of an interest in possession, will not work because there is no such interest. The obvious solution would be to charge tax upon the distribution of capital. That would be insufficient, however, for the capital may not be distributed until the end of the trust period. In any case, provision is needed for a method of determining the rate of tax upon a capital distribution.

Tax is charged upon the making of capital distribution, and also upon some other events which are treated as capital distributions.<sup>48</sup> The most important of these events, discussed below, are: (1) the changing of a discretionary trust into a trust with an interest in possession<sup>49</sup> or into an accumulation and maintenance trust;<sup>50</sup> and (2) the expiration of ten-year periods when tax is chargeable at thirty percent of the rate at which it would be chargeable if the whole fund were distributed.<sup>51</sup> In this way tax is chargeable if the corpus is kept in the trust, distributed, or if the trust is converted into another type of trust. Distributions of income are charged to income tax and not to capital transfer tax. Payments either to satisfy expenses or to purchase additions to the trust property are not included.<sup>52</sup>

Once the decision to tax is made, the next problem is the mode of calculating the tax on a capital distribution. Here, again, with no person entitled to an interest in possession, there is no obvious

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46. *Id.*, para. 4(4).

47. *Id.*, para. 5.

48. *Id.*, para. 6(1), (4); but there is no charge if the distribution is to the trustor or to the spouse of the trustor if domiciled in the United Kingdom when the payment is made and resident in the year of assessment.

49. *Id.*, para. 6(2). See also *id.*, para. 6(7), (8).

50. *Id.*, para. 15(3).

51. *Id.*, para. 12. Tax paid on a deemed capital distribution is credited against what is due on a subsequent distribution payment. *Id.*, para. 11(8).

52. *Id.*, para. 11(7).

person to use as the purported donor. The tax is determined according to a formula laid down in Schedule five, paragraphs seven and eight of the Act. In the case of a capital distribution, which is an actual payment of capital (as opposed to a constructive capital distribution), the amount on which tax is chargeable will be the actual payment, grossed up<sup>53</sup> unless the recipient bears the tax. In the case of capital distributions which do not involve an actual payment, the value is (1) the amount of property in which a fixed interest in possession is created, or (2) the amount of property which becomes subject to an accumulation and maintenance settlement, or (3) in the case of periodic payment, the capital of the trust.<sup>54</sup> Thus there is no grossing up.

The detail of paragraphs seven and eight is very complex.

In general, the rate of tax charged on distributions up to the amount of the original trust capital is the rate, on the lifetime scale, that would have been charged on a gift of that amount by the trustor at the time when he made the trust (para 7(2)). Distributions in excess of the original trust capital fall into the higher rate bands as further gifts by the trustor would have done, (para 7(3)). If however [the trust was created before] 29 March 1974 distributions out of that property are charged on the progressive scale as if they were the only series of gifts made by an individual, (para 8).<sup>55</sup>

Transitional relief is given for trusts created before March 27, 1974, by providing that capital payments made to beneficiaries prior to April 1, 1980, shall be taxed at lower rates, varying annually.<sup>56</sup> Thus, capital distributions made prior to April 1, 1976, are charged at only ten percent of the rate which would otherwise be chargeable. In the final year of the relief, ending March 31, 1980, the rate is twenty percent.

Thus, the tax operates very harshly upon trusts; and most trusts, as has been seen, have lost their tax saving qualities. The policy is to ensure that family capital is charged once a generation.

#### *Accumulation and Maintenance Trusts*

Accumulation and maintenance trusts (and protective trusts and some others) are given favorable treatment under the transfer tax. An accumulation and maintenance trust is one in which no interest in possession exists but in which one or more beneficiaries will, on attaining a specified age not exceeding twenty-five years, become

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53. *Id.*, para. 6(4).

54. *Id.*, para. 6(5).

55. Revenue Circular, April 8, 1975.

56. F.A. 1975, c. 7, Sched. 5, para 14. See also *id.* sub-para. 4, para. 6(2).

entitled to an interest in possession.<sup>57</sup> The income is available for the maintenance of the beneficiaries during their minority, and surplus income not required for maintenance is accumulated.<sup>58</sup> Unless expressly excluded, the trustees have a statutory power to advance up to one-half of a beneficiary's expectant share of the capital.<sup>59</sup>

It has long been common practice to create such trusts in favor of minor relatives. This had estate duty advantages to the trustor as well as income tax advantages except when the beneficiaries were children of the trustor.<sup>60</sup> With regard to all other beneficiaries, the income of the trust is taxed at the basic rate of income tax,<sup>61</sup> which is adjusted to the tax status of the beneficiary with respect to payments made to him or applied for his maintenance or education. If the beneficiary is the child of the trustor, the income of the trust is attributed to the trustor. For a time during the late 1960's, the trust income of minor children was attributed to their parents, regardless of who created the trust. A return to this situation has been promised. For the time being, however, tax advantages remain in the case of trusts in favor of nephews, nieces, grandchildren, and any persons other than the minor children of the trustor.

If capital transfer tax were charged when the beneficiary's interest vested in the income or capital or when an advancement of capital was made to a beneficiary, there would be an element of double taxation; for tax will be payable also when the beneficiary disposes of the interest or dies. Accordingly, no tax is payable when a payment of capital is made to a beneficiary, when an advancement is made, or when his interest vests. In addition, the periodic charge does not apply if the trust continues for ten years or more.<sup>62</sup> Because of these advantages, provision is made for tax to be payable when a discretionary trust is converted into an accumulation and maintenance trust.<sup>63</sup>

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57. *Id.*, Sched. 5, para. 15(1).

58. Trustee Act of 1925, 15 & 16 Geo. 5, c. 19, § 31.

59. *Id.*, § 32.

60. Income and Corporation Taxes Act of 1970, c. 10, § 437.

61. To which is added the investment income surcharge. F.A. 1973, c. 51, § 13.

62. F.A. 1975, c. 7, Sched. 5, para. 15(2).

63. *Id.*, para. 15(3).

## *Protective and Other Trusts*

Other forms of trusts entitled to special treatment are protective trusts,<sup>64</sup> superannuation schemes,<sup>65</sup> trusts for the benefit of employees<sup>66</sup> and for mentally disabled persons,<sup>67</sup> charitable trusts,<sup>68</sup> and various special compensation funds, such as those maintained by the Stock Exchange, Lloyd's, and the Law Society.<sup>69</sup>

### FUTURE INTERESTS EXEMPTIONS AND RELIEFS

Whether vested or contingent, future interests<sup>70</sup> arising under a trust are excluded from the operation of the tax unless they have at any time been acquired for a consideration in money or money's worth.<sup>71</sup> The reason is that trust property is already taxed once per generation. A gift of a reversionary interest expectant on an interest in possession would be an additional charge. When a reversionary interest has been sold, it becomes a commercial interest in its own right and thus taxable upon transfer. If a life tenant acquires a reversion expectant upon the termination of his life interest, there is a transfer of value by him if he pays consideration for the reversion. Because a reversionary interest is excluded property, it does not become part of the estate of the person acquiring it; thus the consideration paid is treated as a gift.<sup>72</sup> If this were not so, a life tenant could deplete his estate by buying the reversion. As a life tenant, he is treated for tax purposes as the owner of the trust property.<sup>73</sup>

### *Foreign Property*

Certain foreign property is excluded depending on the location of the property and the domicile of the owner. For purposes of the capital transfer tax, domicile is specifically defined<sup>74</sup> so as to prevent people domiciled or resident in the United Kingdom from gaining too easily advantages of foreign domicile and residence.

### *Inter-Spousal Transfers*

Until recently, the surviving spouse had been harshly treated by

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64. *Id.*, para. 18.

65. *Id.*, para. 16.

66. *Id.*, para. 17.

67. *Id.*, para. 19.

68. *Id.*, para. 20.

69. *Id.*, para. 21.

70. An interest expectant on the termination of a lease is excepted.

71. F.A. 1975, c. 7, § 24(3). There are exceptions.

72. *Id.*, §§ 20(4), 23(3).

73. *Id.*, Sched. 5, para. 3(1).

74. *Id.*, § 45.

estate duty law. Before 1972, the only concession was that a limited interest (usually a life interest) given to a surviving spouse was exempt from estate duty on the surviving spouse's death.<sup>75</sup> Widows believed that the exemption was needed upon the husband's death, in place of a reduction of the family capital at the time when it was most needed. The Finance Act of 1972<sup>76</sup> allowed an exemption in respect to £15,000 in the case of a testamentary gift to a spouse. This, with the personal exemption of £15,000, allowed the spouse to receive £30,000 before duty became payable.

Inter-spousal transfers are in general exempt from capital transfer tax to the extent of the value which becomes the property of the donor's spouse.<sup>77</sup> This exemption applies to both testamentary and *inter vivos* transfers, and does not depend on whether the transfer is to the spouse or on trust for the spouse.<sup>78</sup> But if the donee spouse is domiciled abroad, the transfer is exempt only as to £15,000 in total transfers to the spouse.<sup>79</sup> Whether one spouse can give property to the other for the purpose of enabling that other spouse to make gifts to third parties within his or her exemptions is not clear. Such a transaction would appear to be an associated operation<sup>80</sup> and may be treated for tax purposes as a transfer by the original spouse.

This view was disputed by the Government spokesmen during the Committee stage but on the Report stage the Chief Secretary made a somewhat confusing statement from which it would appear likely that the Revenue will not press the point in straight-forward cases where the wealthier spouse transfers property to the other spouse who later passes it on, but will apply the associated operations provisions to a transfer between spouses if such a transfer is used to reduce values of related property or in other cases which the Revenue regard as blatant avoidance devices.<sup>81</sup>

The gift must be direct in the sense that no exemption exists if the gift takes effect upon the termination of any other interest or after one year, or if the gift depends on a condition which is

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75. F.A. 1894, 57 & 58 Vict., c. 30, § 5(2); F. (1909-10) A. 1910, 10 Edw. 7, c. 8, § 55; F.A. 1914, 4 & 5 Geo. 5, c. 10, § 14.

76. F.A. 1972, c. 41, § 121.

77. *Id.*, 1975, c. 7, Sched. 6, para. 1(1). See also Budget Proposals 1976.

78. *Id.*, para. 15(5).

79. *Id.*, para. 1(2) (accumulating previous chargeable gifts).

80. *Id.*, § 44.

81. G. WHEATCROFT & G. HEWSON, CAPITAL TRANSFER TAX 33-34 (1975) (footnote omitted) [hereinafter cited as WHEATCROFT & HEWSON].

not satisfied within twelve months after the transfer.<sup>82</sup> But, in order to allow provisions for simultaneous death (such as a gift to a spouse conditional on survival for a limited period), the exemption is not lost "by reason only that the property is given to a spouse only if he survives the other spouse for a specified period."<sup>83</sup> And, as has been seen, no tax is chargeable when a spouse becomes entitled to trust property upon the death of the trustor's spouse.<sup>84</sup>

### *Gifts to Charities*

British law has been much less generous than United States law in its treatment of gifts to charity. Until 1972, there was no exemption for testamentary gifts. The only concession was that the "claw back" period, the period preceding death during which gifts would be brought into and taxed as part of the decedent's estate, was one year instead of seven.<sup>85</sup> Now gifts to charities established in the United Kingdom are exempt if made more than one year before death or made as a distribution from a trust.<sup>86</sup> There is a limit of £100,000 in the case of transfers either on death or within one year of death.<sup>87</sup> In the latter case, the transferee charity is liable for the tax, and no grossing up exists.<sup>88</sup>

### *Gifts to Political Parties*<sup>89</sup>

Gifts to political parties are treated in the same way as gifts to charities for the purpose of capital transfer tax. To be a political party for this purpose, it is necessary that, at the general election immediately preceding the transfer, two members were elected to Parliament or that one member was elected and the party polled not fewer than 150,000 votes.<sup>90</sup>

### *Gifts for National Purposes*

Gifts for specific national institutions<sup>91</sup> are exempt whenever made, with no limitation as to value. This exemption follows that accorded under the estate duty system, but the list contains some additional names.

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82. F.A. 1975, c. 7, Sched. 6, para. 15.

83. *Id.*, para. 15(1).

84. See text and authority cited note 43 *supra*.

85. F. (1909-10) A. 1910, 10 Edw. 7, c. 8, § 5(9), *proviso*.

86. F.A. 1975, c. 7, Sched. 6, para. 10(1)(2).

87. *Id.*, para. 10(1).

88. *Id.*, § 26(3).

89. *Id.*, Sched. 6, para. 1.

90. *Id.*, para. 11(2).

91. *Id.*, Sched. 6, para. 12 (listing what are known as "heritage bodies").

*Inter vivos* transfers of certain types of property, specifically listed by statute<sup>92</sup> and considered to be part of the national heritage of the United Kingdom, are exempt from liability if transferred to a non-profit making body, and the Treasury so directed.<sup>93</sup> Thus the Treasury is the judge of whether property comes within the description and may require undertakings be given for the purpose of preserving the property and securing reasonable access by the public.<sup>94</sup>

Similarly, national heritage property may be exempt upon the trustor's death, even if the gift is to an individual, if such individual gives an undertaking to keep the property in the United Kingdom, takes reasonable steps to preserve the property, and provides reasonable public access.<sup>95</sup> Tax becomes payable if the commitment is broken or if the property is disposed of.<sup>96</sup> The rate of tax depends on whether the event takes place within three years after the death.<sup>97</sup>

As with gifts to spouses, all the gifts must be direct; that is, they must not take effect after the termination of another interest or period. The exemption is lost if the gift is subject to a condition which is not satisfied within twelve months of the transfer.<sup>98</sup>

#### *Agricultural and Industrial Property*

Agricultural property was favorably treated for estate duty and charged at only fifty-five percent of its agricultural value.<sup>99</sup> But these advantages are now restricted. The provisions are complex. They draw a distinction between those whose livelihood is farming and those who purchase agricultural land for fiscal purposes. Accordingly, relief will be available only when the transferor is a qualifying working farmer and the property was occupied by the transferor for the purposes of agriculture.<sup>100</sup> A widow who

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92. *Id.*, Sched. 6, para. 13(2).

93. *Id.*, para. 13(1).

94. *Id.*, para. 13(4).

95. *Id.* §§ 31-34.

96. F.A. 1975, § 32(3) (a) (unless sold to one of the approved bodies for the National Purposes exemption), note 90 *supra*.

97. *Id.*, § 43(7) (8).

98. *Id.*, Sched. 6, para. 15(2).

99. F.A. 1949, 12, 13, & 14 Geo. 6, c. 47, § 28(1), *amending* F.A. 1925, 15 & 16 Geo. 5, c. 36, § 23(1).

100. F.A. 1975, c. 7, Sched. 8, para. 3(1).

inherits qualifying property on her husband's death is treated as a working farmer if her husband was such at the time of his death.<sup>101</sup> The tax benefit<sup>102</sup> is limited to fifty percent, and to a value of £250,000 or an area of 1,000 acres.<sup>103</sup>

Similarly, relief is given with respect to property used for business purposes, but not when the decedent was in the business of dealing in property or in stocks and shares. The property must have been owned for at least two years prior to the transfer; then the value of the property transferred may be reduced for capital transfer tax purposes by thirty percent.

### *Lifetime Transfers*

A number of minor exemptions exist in respect to *inter vivos* transfers. There is an annual exemption of £2,000 per transferor<sup>104</sup> and additional exemption of £100 per transferee.<sup>105</sup> Gifts made in consideration of marriage by a parent of a party to the marriage are exempt up to £5,000. Also exempt are gifts of £2,500 or less by a more remote ancestor or by a party to the marriage and gifts of £1,000 or less by any other person.<sup>106</sup> Transfers in the course of a trade, profession, or vocation are exempt if they would be allowable as a deduction in computing for income tax purposes the profits of the trade, business, or profession.<sup>107</sup> Further, the tax is a tax on transfers of capital. Payments out of income are exempt so long as the transferor can show that they were part of his normal expenditures and that he was left with sufficient income to maintain his usual standard of living.<sup>108</sup>

### *Transfers on Death*

Tax is not chargeable on the estate of a person who dies while on active service with the armed forces or with the auxiliary services.<sup>109</sup> Also exempt are options arising under approved annuity schemes<sup>110</sup> and various overseas pensions.<sup>111</sup>

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101. *Id.*, para. 3(6).

102. Budget Proposals 1976.

103. F.A. 1975, c. 7, Sched. 8.

104. *Id.*, Sched. 6, para. 2. The amount was increased from £1,000 by the Finance Act of 1976. The unused part of this amount may be carried forward for one year. F.A. 1975. *Id.*, para. 2(2).

105. *Id.*, para. 4.

106. *Id.*, para. 6.

107. *Id.*, para. 9 (such as a gratuity to a retiring employee).

108. *Id.*, para. 5(2).

109. *Id.*, Sched. 7, para. 1.

110. *Id.*, para. 2.

111. *Id.*, para. 4.

### *Woodlands*

The purchase of woodlands prior to death was one of the accepted loopholes to estate duty liability.<sup>112</sup> The argument in favor of this exemption is ecological. If no fiscal advantage existed, there would be little incentive to purchase and preserve woodland, and the environment would suffer accordingly. The present law accepts this argument but attempts to prevent the privilege from being used solely for fiscal purposes.

According to a plan approved by the Forestry Commission, woodlands qualify for special treatment if the property was owned by the decedent for five years preceding his death.<sup>113</sup> The person liable for the tax may elect to have the value of the trees or underwood omitted from the value of the estate upon his death.<sup>114</sup> Tax is paid only on the value of the land. If the trees or underwood are sold with or separately from the land, tax is chargeable on their value at the highest rate applicable to the estate from which the value of the woodlands was omitted.<sup>115</sup> Thus, woodlands retained in the family are free of tax.

#### EFFECT ON TAX PLANNING

The changes made in the taxation of trusts will have considerable effect upon trust practice. It is too early yet to foresee developments in detail, but some comments can nevertheless be made upon likely trends.<sup>116</sup>

### *Transition Legislation for Existing Estate Plans*

The most urgent question relates to trusts which were designed to take advantage of estate duty loopholes and now have become especially vulnerable to the capital transfer tax.

### *Trusts with an Interest in Possession*

If one accepts that tax is to be paid on family capital once a generation, a life interest to parents with gifts over to the children has

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112. See Maudsley, *supra* note 21, at 290.

113. F.A. 1975, c. 7, Sched. 9, para. 5.

114. *Id.*, para. 1.

115. *Id.*, para. 3.

116. See WHEATCROFT & HEWSON, *supra* note 81, ch. 12.

no special disadvantage in terms of tax. The tax payable upon the life tenant's death is the same as if the life tenant had been the beneficial owner of the capital.<sup>117</sup> A series of life interests within the same generation should be avoided,<sup>118</sup> for tax will be payable on successive deaths with only the quick succession relief to help in part.<sup>119</sup> The worst of all worlds is a life interest followed by a discretionary trust.

Steps can be taken to improve the tax situation of successive life interests by disposing of successive interests before they fall into possession. Reversionary interests are, as has been seen, excluded property, but if the life tenant buys such an interest, the purchase money counts as a gift by him.<sup>120</sup> Tax on the life tenant's death can be saved in part by an *inter vivos* division of the trust property. In the ordinary case of a limitation to A for life and after his death to B, A and B could agree to divide the property between them, based upon the actuarial value of their interests. Assume that the trust property is worth £100,000 and A's life interest is worth £40,000, and B's reversion worth £60,000. Tax will be payable upon £60,000, because the life interest comes to an end as to that portion; no tax is payable on the £40,000 because upon termination of that portion of the life estate, A becomes entitled to another interest in possession in the property.<sup>121</sup> If the trust is broken in this way, the beneficiaries will have capital sums instead of interests under the trust. There is no difficulty in Britain in terminating trusts, provided that the entire beneficial interest is vested in persons who are adult and under no disability, and all consent to the termination.<sup>122</sup>

When minors or others under disability are involved, as is usual in the case of family trusts, it is necessary to obtain a court order for the termination of the trust under the Variation of Trusts Act of 1958. The court must be satisfied that the variation is for the benefit of those people on whose behalf it approves,<sup>123</sup> and an accumulation and maintenance trust is usually set up for the benefit of minor beneficiaries.

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117. F.A. 1975, c. 7, Sched. 5, para. 3(1).

118. *But see id.*, Sched. 5, para. 4(6) (reverter to trustor's spouse); and *id.*, para. 4(7) (estate duty relief on death of surviving spouse with limited interest).

119. *Id.*, Sched. 5, para. 5.

120. *Id.*, § 23(3).

121. *Id.*, Sched. 5, para. 4(3), (4).

122. *Saunders v. Vautier* (1841) 4 Beav. 115, 49 Eng. Rep. 282, *aff'd*, Cr. & Ph. 240, 10 L.J. ch. (N. 5) 354, 41 Eng. Rep. 482.

123. Variation of Trusts Act of 1958, 6 & 7 Eliz. 2, c. 53, § 1.

*Trusts in Which There is no Interest in Possession*

Discretionary trusts have been the hardest hit by the new legislation. Tax is chargeable when a capital distribution is made, as well as when a transfer is deemed to have been made. It is difficult to see how discretionary trusts can have any attraction in the future in the context of tax saving. "It seems unlikely," say Wheatcroft and Hewson,<sup>124</sup> "that many [trusts] with no interest in possession will be created after March 26, 1974 . . . ." The hardship created to many existing discretionary trusts which for years have been free from any estate duty liability is obvious. As a result of pressure put upon the Government during Parliamentary discussions of the bill, the Act in its final form allowed substantial concessions in respect to capital distributions made before April 1, 1980, as has been explained.<sup>125</sup> If a distribution is made prior to April 1, 1976, the tax is only ten percent of what it would otherwise have been. Assuming the trust is a pre-March 27, 1974 trust, distributions are taxed as if they were distributions by an individual who had made no prior distributions;<sup>126</sup> thus, the first £15,000 is tax free and subsequent distributions must be aggregated and grossed up. "The basic problem now for trustees of such [trusts] is to decide whether to make early distributions, . . . or to . . . suffer higher rate tax on the periodic charge or later distributions . . . ."<sup>127</sup> Immediate distribution of the capital will be a common solution and, when minors are involved, conversion into an accumulation and maintenance trust for their benefit is recommended. This advice is all the more urgent in the case of discretionary trusts when the trustees are resident abroad. The concessions are available in the case of actual distributions to people domiciled and resident in the United Kingdom, but not in respect to the annual charge which is imposed upon trusts whose trustees are not resident in the United Kingdom.<sup>128</sup>

*Estate Planning Considerations Under the New Law*

The first point to appreciate is that, with lower rates of tax charged on gifts made more than three years before death, lifetime

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124. WHEATCROFT & HEWSON 114.

125. F.A. 1975, c. 7, Sched. 5, para. 14.

126. *Id.*, para. 8.

127. WHEATCROFT & HEWSON 114.

128. F.A. 1975, c. 7, Sched. 5, para. 14(4), (5).

transfers continue to effect a saving of tax. It will be seen that up to £100,000, the rates for *inter vivos* transfer are half those for death transfers. A smaller saving is made on lifetime gifts up to £300,000, after which the rates are the same. All this is consistent with the apparent policy of the Act, which is to charge most severely the very rich trustors; the "middle rich" will often fare better under the Act than they would have done under the estate duty system.

### *Benefits to the Trustor*

Under the estate duty system, it was essential to ensure that the trustor was deprived of any benefit under the trust. If he received any benefit or was in a position in which he might receive any benefit, the whole capital of the trust, however long ago it had been established, was treated for estate duty purposes as part of his estate.<sup>129</sup> Although the law has changed, the current situation is not clear. If the owner of property transfers it into trust for himself absolutely, no tax is payable because the value of this estate is not decreased. If he creates a trust with himself as life tenant, the position is presumably the same, because the owner of an interest in possession under a trust is treated for capital transfer tax purposes as if he were the beneficial owner of the trust property.<sup>130</sup> It seems, however, that there is a way in which the trustor could take advantage of the lower rates applicable to *inter vivos* transfers and still have the security of using the property for his own benefit, if needed. He could create an *inter vivos* trust with an interest in possession and give to the trustees an overriding power to appoint capital in his favor. A revocable trust would presumably have no capital transfer tax advantages. In all these cases the income tax situation must also be watched.

### *Exemptions and Gifts*

The permitted exemptions allow considerable scope for passing on family wealth of medium proportions to the next generation. The £15,000 exemption and annual £2,000 exemptions are available to each spouse in addition to the annual £100 exemption per donee. Thus, without incurring any liability to tax, the parents could set up a £30,000 trust and add £4,000 each year to it. They can also make gifts of £100 to each of the children each year, gifts of £5,000

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129. *Commissioner of Stamp Duties v. Permanent Trustee Co.*, [1956] A.C. 512; *Chick v. Commissioner of Stamp Duties* [1958] A.C. 435.

130. F.A. 1975, c. 7, Sched. 5, para. 3(1).

to each child on marriage, and make payments for their maintenance and education and payments out of income which are regarded as normal expenditure.<sup>131</sup>

An interest-free loan may also be advantageous. The lender is treated as making a transfer of the difference between the amount of interest charged and that which could reasonably be expected to have been charged, but such a transfer is treated as being made out of the transferor's income, and, provided that he is left with sufficient income to maintain his normal standard of living, the transfer will again be exempt.<sup>132</sup> If more money is available, greater sums can be given, incurring tax at the lower rates for *inter vivos* transfers. In this way, a six-figure trust for the children could be built up with a minimum of tax liability.

The question of whether one richer spouse can give to the other and that other make exempt gifts was discussed above.<sup>133</sup> Further gifts to charities and other exempt institutions may also be made.

#### *Transfers Between Spouses*

Spouses have separate personal exemptions, and what a single person can do in relation to exempt gifts, each spouse can do. Transfers between spouses *inter vivos* and at death are exempt to an unlimited extent. Indeed, if every widow and widower remarried and passed on the family fortune to the new spouse, no capital transfer tax would ever be payable, provided they died in the correct order. That theoretical form of tax avoidance is no problem for the government, and the real question for consideration is the best way to take advantage of the permitted transfers between existing spouses.

The most favorable way of arranging marital property from a tax perspective is to equalize the estates of the spouses by *inter vivos* transfers and to have each spouse leave his or her whole estate elsewhere. The surviving spouse, however, would receive no benefit under the will of the first spouse to die. Tax could be avoided on the death of the first by leaving the whole estate to the survivor. But upon the survivor's death, tax is payable on the

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131. *Id.*, Sched. 6, para. 5.

132. *Id.*, § 41.

133. See text accompanying notes 76-83 *supra*.

aggregate.<sup>134</sup> As always, it is necessary to consider the facts of each case and to balance the needs of the surviving spouse and the advantages of the tax saving to the ultimate takers. With all the unknown factors relevant to this type of situation (a long widowhood, inflation, changes in tax rates), regular review of the situation is important.

### *Testamentary Dispositions*

Various questions need to be considered in connection with testamentary gifts. The exemptions applicable to transfers upon death have been considered. If the gift is subject to tax, consideration should be given to the method of payment. The tax may be paid in installments in some situations.<sup>135</sup> Payment may be facilitated by the use of life policies, vested in the intended beneficiaries, for these can be cashed immediately, even before probate.

The testator should also consider the effect of the tax upon the beneficiaries under a settlement. If fixed interests are created, tax will be payable upon their determination, whether upon death, remarriage, or for other reasons.<sup>136</sup> With discretionary trusts, capital distributions are taxable, and, with a trust created after March 26, 1974, the rate will be high in the case of a wealthy trustor, for it will be effected by the rate of tax payable upon the transfer creating the trust.<sup>137</sup> Further, the common practice of giving money or personal property to a trusted individual, requesting him, but without imposing a trust, to distribute the property according to some pattern indicated by the testator may create tax problems for the legatee upon distribution. All in all, the common testamentary pattern will probably be to make absolute gifts or to create accumulation and maintenance or protective trusts.

### CONCLUSION

Estate and gift taxation serves two purposes: raising revenue and levelling wealth. As designed by Parliament, the transfer tax can effectively and equitably accomplish both goals. Capital will

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134. If a married couple has combined assets of £400,000, and the first spouse leaves everything to the survivor, the tax payable on the second death (assuming no previous gifts) would be £204,750. If the spouses equalized their wealth by *inter vivos* transfers, and the first to die leaves nothing to the survivor, the tax payable on each death would be £84,750, making a total of £169,500. WHEATCROFT & HEWSON 111.

135. F.A. 1975, c. 7.

136. *Id.*, Sched. 5, para. 4(2).

137. *Id.*, para. 7.

be taxed each generation, and few means exist for avoiding or lessening this tax.

The United States estate and gift tax was originally designed as a revenue raiser, not as a leveller of wealth. The United States system still lacks the consistency and equity of the British transfer tax. The assessed tax is determined as much by the manner in which the property is transferred as by the amount that is transferred. Similar taxpayers making similar transfers may be taxed quite differently depending on the gift, trust, or estate plans used. The British transfer tax could provide a useful model when further consideration is given to the question of estate and gift tax reform in the United States.