Inheritance tax: the nuances of ‘interest in possession’

Inheritance tax and trusts

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The case of *Hall v HMRC* raises questions about the nuances of ‘interest in possession’.

Key Points

What is the issue?

Mrs Raboni’s will provided for her house to be retained as Mr Boggia’s home during his lifetime and for him to live there without charge (subject to costs). However, there was insufficient cash in the estate for inheritance tax to be paid. The residuary beneficiaries agreed to retain the house as an investment and pay the inheritance tax from their own resources.

What does it mean for me?

HMRC considered that, immediately before his death, Mr Boggia had an interest in possession in the house and determined that inheritance tax was due on his death.

What can I take away?

The case suggests that cash-poor estates can confer interests that fall short of an interest in possession. Advisers who deal with inheritance tax have to think carefully about similar arrangements and, where possible, take pre-emptive action to avoid unnecessary uncertainties.

Before the sudden reforms of the inheritance tax rules in March 2006, there was a fundamental distinction between life-interest trusts and discretionary trusts. This distinction can still be significant for all taxes (including inheritance tax). Furthermore, the nature of the trust will be of considerable importance in guiding how the trustees administer the trust (and the beneficiaries' rights under the trust). Nevertheless, it must be said that, for inheritance tax purposes, the distinction is no longer quite as fundamental as it once was.

A life interest trust is one in which a beneficiary, the 'life tenant', has an 'interest in possession' in the settled property. That phrase was explained by the House of Lords in the case of *Pearson v Inland Revenue Commissioners* [1981] AC 753 as 'a present right to present enjoyment [of the trust property]'. Typically, this means cases where a life tenant is entitled to the income (e.g. interest or dividends) arising from an investment; or, in the case of real property, has the right to occupy the property or to receive the rental income arising. What the life tenant cannot do is receive the underlying capital (being the investment itself). That capital must be preserved for a subsequent beneficiary (either for the enjoyment of another life tenant or a beneficiary who is then entitled to the trust assets absolutely, thereby bringing the trust to an end).

The case of *Hall and another (as trustees of the Carolina Raboni estate) v HMRC* [2023] UKFTT 32 (TC) has caused practitioners to have a fresh look at the *Pearson* definition.

The facts of the case

Mrs Raboni was a widow living in a house in East Finchley. Living nearby was a divorcee, Mr Boggia. Mr Boggia was living with his sister, who was a friend of Mrs Raboni. Mr Boggia had also been a friend of Mrs Raboni and her late husband.

The precise factual background is uncertain (and not strictly relevant). However, by 2002, Mr Boggia was regularly visiting Mrs Raboni, kept her company, did her food shopping, cleaned and looked after her garden. When Mrs Raboni’s health declined in 2003, Mr Boggia began to spend a few nights a week at Mrs Raboni’s house, staying in a spare bedroom and keeping a change of clothes there.

Mrs Raboni made her last will in July 2003. She left the residue of her estate to be shared amongst her five nieces and nephews, together with Mr Boggia’s sister. However, the will also provided for Mrs Raboni’s house to be retained as Mr Boggia’s home during his lifetime, and for him to live there without charge (subject to him being responsible for insurance and maintenance costs). Mrs Raboni died in 2004.

When probate was obtained, the gross value of the estate was a little over £308,000, with the house representing the lion’s share of that (having an agreed probate value of £300,000). Debts brought the net value of the estate down to just over £302,000. With a nil-rate band then of £263,000, this meant that the estate had an inheritance tax liability of about £15,600. As will be clear from the preceding figures, there was insufficient cash in the estate that would allow that tax to be paid.

Mrs Raboni’s executors took legal advice and duly advised the beneficiaries that the house would need to be sold if the estate were to raise the funds to discharge the inheritance tax liability. However, the advice made clear that any such sale would have to be subject to Mr Boggia’s right of occupation (which would no doubt reduce the proceeds that could be raised). The residuary beneficiaries agreed, instead, to retain the house as an investment and, in the meantime, to pay the inheritance tax from their own resources. It is implied in the decision that they took advantage of the right to pay that inheritance tax in instalments over ten years.

This appears to have been a wise decision as the house was eventually sold for £827,000 following Mr Boggia’s death in 2017. It was that event that then gave rise to the present case.

HMRC considered that, immediately before his death, Mr Boggia had an interest in possession in the house and, accordingly, determined that inheritance tax was due on his death. HMRC's determination was the subject of an appeal which was duly notified to the First-tier Tribunal.

The First-tier Tribunal's decision

The case came before Judge Sarah Allatt.

In the course of her decision, the Judge helpfully cited in full the relevant provision of Mrs Raboni's will by which she provided that her house may not be sold or disposed of during Mr Boggia's lifetime without his consent; and that it should in the meantime be retained as his home for as long as he so desired and without charge (but for the duty to pay for the house's maintenance and insurance).

Mr Boggia had no right to be given any alternative accommodation if he moved out of what had been Mrs Raboni's home.

The Judge also recorded what was common ground between the parties, being that:

1. if Mrs Raboni's estate had had sufficient liquid assets to discharge the inheritance tax liability, the terms of Mr Boggia's occupation of the house would have amounted to an interest in possession; and
2. had the house been sold to pay the inheritance tax, no interest in possession would have existed.

The Judge considered the various scenarios (both actual and hypothetical) that could have arisen on the basic facts of the case. For example, what would have happened had one or more of the beneficiaries not agreed to pay the inheritance tax and instead required the house to be sold? However, the Judge considered that what was important was not what could have happened but what the various parties' ultimate rights were.

Having considered the executors' competing duties to administer the estate, to collect its assets for the benefit of the beneficiaries and to pay any inheritance tax, the Judge concluded that the executors could have required the sale of the house in order to pay the remaining inheritance tax liability. However, noting the common ground between the parties (referred to above), as Mr Boggia had no right to any alternative accommodation, the Judge concluded that this meant that he did not have an interest in possession in the house.

As a result, the Judge allowed the appeal.

Commentary

Many commentators appear to be somewhat surprised by the outcome of the case and expect that HMRC will want the case to proceed to the Upper Tribunal for further consideration. Without rushing to say that the First-tier Tribunal has got it wrong, I would certainly say that its decision is not in accordance with my initial view of the facts. (Indeed, the trustees of Mrs Raboni’s will trust initially paid inheritance tax on Mr Boggia’s death on the assumption that Mr Boggia had an interest in possession in the house. It was only after some further thought that they sought a repayment which was refused by HMRC. It was that refusal which led to the determination that was the subject of the appeal to the First-tier Tribunal.)

At the heart of the First-tier Tribunal’s decision is the fact that Mrs Raboni’s estate could not discharge the full inheritance tax liability without selling the house. It was this fact that led to the First-tier Tribunal concluding that Mr Boggia’s interest fell short of a right to present enjoyment of the property.

However, the initial difficulty I have with this logic is its relationship with the earlier assumption that any sale of the property would have had to have been subject to Mr Boggia’s continued right of occupation. To be fair to the First-tier Tribunal, the Judge did comment that this assumption was based on legal advice received by the executors and that the legal advice might well have been incorrect. As the Judge noted: ‘[I]t is extremely unclear whether that is the correct legal position, and whether a different firm would have advised differently.’ However, it appears that the Judge did not actually then consider this legal question herself, even though in my view its resolution is essential for the correct determination of the issues in the case.

Furthermore, the Judge appears to have been swayed by what was said to be common ground being that, if the property had to be sold, then no interest in possession would have subsisted. However, I read that common ground as predicated on a forced sale of the property in circumstances where Mr Boggia would have been required to leave the property. If, as the executors were advised, any such sale would have had to have taken place subject to Mr Boggia’s continued occupation, then such a sale could not have displaced Mr Boggia’s interest in possession.

It is for this reason that I think that the Judge should have addressed the correctness of the advice received by the executors.

On the numbers arising in the case, it would seem likely that a sale could have taken place on terms which preserved Mr Boggia’s right of occupation and still raised enough money to clear the inheritance tax liability. For this reason, my own assumption is that the legal advice obtained was probably correct. But, if this is the case, then it would seem that Mr Boggia would have had an interest in possession in the same way as if the estate had had enough liquid funds to pay the tax in the first place.

In contrast, had the value of the house been considerably higher, it is quite possible that a sale of the underlying interest in the house (i.e. subject to Mr Boggia’s continued occupation) would not have raised sufficient money to discharge the inheritance tax charge. In such a case, it would have been interesting to see whose interests would prevail: an elderly man who would otherwise be homeless; or the Exchequer.

If HMRC’s demand for the tax would have prevailed then, on the First-tier Tribunal’s logic, it is possible that there was no interest in possession. However, that issue is something that would still merit the consideration of the Upper Tribunal.

As a result, I believe that this is a case of wider interest and hope that it does proceed to the Upper Tribunal. In the circumstances, this case strikes me as an appropriate one for HMRC to make special arrangements so that, for example, were they to succeed in the Upper Tribunal, they would not seek their costs.

What to do next

For advisers who work in this area, it would be worth looking out for any statements of practice issued by HMRC which comment on this decision or for any sign that the case is to proceed to the Upper Tribunal.

In the meantime, the case suggests that cash-poor estates can confer interests that fall short of an interest in possession. But, if an interest in possession does not exist, does this mean that the more onerous regime for relevant property (defined as ‘settled property in which no qualifying interest in possession subsists’) applies?

Advisers who deal with inheritance tax are certainly going to have to think carefully about similar arrangements and, where possible, take some pre-emptive action so as to avoid unnecessary uncertainties.