Tread carefully

Guy Abrahams assesses Buzzoni v HMRC, *which indicates the court's current attitude towards reversionary lease schemes*

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'If Mrs Kamhi had not been required by her landlord to obtain covenants from the tenant, and therefore been able to grant Ovalap a covenant-free underlease, it seems that the underlease would have achieved its intended purpose.'

The case of *Buzzoni v HMRC* [2012] concerned a scheme designed to reduce inheritance tax by taking advantage of the principle identified by the House of Lords in the *Ingram* case (*Ingram v Commissioners of Inland Revenue* [2000]).

As a reminder, that case concerned a plan implemented by Lady Ingram, then in her seventies, who owned the freehold of her Berkshire home. In order to reduce her taxable estate she granted herself a lease (through a nominee) of the house and grounds, gave away the freehold to trustees for the benefit of her children and grandchildren, and continued to live in the property. The freehold became more valuable as the unexpired term of Lady Ingram's lease diminished, thus gradually reducing her taxable estate. After her death HMRC argued that the freehold she had given away was 'property subject to a reservation' under s102 Inheritance Tax Act 1984:

(1) … this section applies where, on or after 18 March 1986, an individual disposes of any property by way of gift and either –

(a) possession and enjoyment of the property is not bona fide assumed by the donee…; or

(b) the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise…

(2) If and so long as –

(a) possession and enjoyment of any property is not bona fide assumed as mentioned in sub-section (1)(a) above, or

(b) any property is not enjoyed as mentioned in subsection (1)(b) above, the property is referred to (in relation to the gift and the donor) as property subject to a reservation.

(3) If, immediately before the death of the donor, there is any property which, in relation to him, is property subject to a reservation then… that property shall be treated for the purposes of the 1984 Act as property to which he was beneficially entitled immediately before his death.

HMRC contended that the freehold remained part of Lady Ingram's estate on her death and was subject to tax accordingly. The House of Lords, however, held that Lady Ingram's gift was of a discrete interest in property – the freehold – in which she did not reserve a benefit, and that her continuing occupation of the property was by virtue of the leasehold interest only.

A few months after the decision, the Finance Act 1999 inserted s102A into Finance Act 1986 to stop 'Ingram schemes' proliferating. Section 102A extended the scope of s102 to apply not just to 'interests' in land but to 'significant arrangements', which entitled or enabled:

> … the donor to occupy all or part of the land, or to enjoy some right in relation to all or part of the land, otherwise than for full consideration in money or money's worth.

Section 102A applied to disposals of interests in land made after 9 March 1999, and *Ingram* schemes ceased to be effective.

Arguably, reversionary lease schemes – in which a freeholder grants a lease taking effect in the future, continuing to occupy the property in the meantime – were not affected by s102A. *Buzzoni* was essentially a reversionary lease scheme where the donor owned not the freehold but a lease. The case highlights a number of pitfalls that might, in principle at least, have been avoided by careful planning.

Facts

Mrs Kamhi was the tenant under a long lease of a flat in Knightsbridge. She created a settlement in favour of her sons. In 1997 she granted a rent-free underlease to the trustee's nominee, Ovalap Ltd, to commence in 2007. (For convenience I will continue to refer to the tenant of the underlease as Ovalap although, beneficially, the underlease belonged to the trustee of Mrs Kamhi's settlement.)

The essence of the arrangement was as simple as that in *Ingram*: Mrs Kamhi's grant of the underlease in 1997 would be a potentially exempt transfer (PET). The value transferred by that PET would be quite low, as the term of the underlease would not commence until ten years later. The underlease would increase in value as 2007 approached, while the value of Mrs Kamhi's superior leasehold interest would correspondingly diminish and so reduce her taxable estate.

Importantly – the decision turns mainly on this – the underlease contained covenants by Ovalap in favour of Mrs Kamhi. This was unavoidable because the landlord would not let Mrs Kamhi sub-let her property unless she obtained covenants from her tenant, which mirrored those in the headlease. The most important covenant in the underlease, for the purposes of the litigation, indemnified Mrs Kamhi against any service charges she was required to pay the landlord.

Mrs Kamhi died in Turkey in May 2008 and HMRC argued that she had reserved a benefit in the underlease, meaning that it was part of her taxable estate.

Decision

Mrs Kamhi's executors appealed against HMRC's assessment on a number of grounds. The First Tier Tribunal held against them, as did the Upper Tribunal on their further appeal. The arguments put forward by Mrs Kamhi's executors before both tribunals were much the same, the principal one being that the underlease, including the covenants, was a single property interest and that this was what Mrs Kamhi had transferred. Thus the covenants were not reserved benefits but were no more than 'an inherent part of the character of the alienated property'. They argued that Ovalap's obligations in the underlease simply 'defined' the extent of the interest Mrs Kamhi had given away, while HMRC maintained that Mrs Kamhi had given away an interest in land but reserved to herself the benefit of the covenants.

There is a rather fine but crucial distinction here, which was expressed very succinctly in the Australian case of *Oakes v Commissioner of Stamp Duties New South Wales* [1954]:

> The contrast is between [i] reserving a beneficial interest and only giving such interests as remain [as Lady Ingram did] on the one hand, and on the other hand [ii] reserving power to take benefit out of, or at the expense of interests which are given.

So the central issue was this: were the covenants an intrinsic part of the leasehold interest, or were they a discrete and severable collection of rights that had been added to that interest by Mrs Kamhi and which thus constituted a benefit reserved by her?

This raised the fundamental question: what is required to constitute a lease? The First Tier Tribunal referred to s205(1) Law of Property Act 1925, which provides that a 'term of years absolute' [ie a lease] is:

> a term of years (taking effect either in possession or in reversion whether or not at a rent)...

The First Tier Tribunal (which was happy to categorise service charge as rent) concluded that 'reservation of rent is therefore a choice and not an incident of the lease'. The Upper Tribunal agreed, holding that:

> ... payment of rent and service charges is not an essential feature of a lease... It is possible to grant a lease without covenants. The covenants themselves do not constitute an interest in land.

Once the Tribunal had reached this conclusion on the central issue, the appellants' case began to fall away.

The most important covenant in the underlease, for the purposes of the litigation, indemnified Mrs Kamhi against any service charges she was required to pay the landlord.

If a leasehold interest is something that can exist independently of any of the tenant's obligations (apart, one assumes, from the requirement to vacate at the end of the term), then any covenants in favour of the landlord are 'extras' imposed on the tenant. Mrs Kamhi had obtained various covenants from Ovalap, most importantly the covenant to pay the service charge. Provided these constituted benefits to her, then Ovalap did not enjoy possession of the underlease to the entire or virtual exclusion of Mrs Kamhi.

There was, for the appellants, a rather unhelpful passage in Lord Hoffmann's judgment in Ingram on which the Upper Tribunal relied:

> ... a lease is a contract as well as an estate. It involves obligations between the parties enforceable in contract or by virtue of privity of estate. It cannot therefore be regarded as the mere reservation of property like a life interest... [I]f, in addition to the leasehold estate which she reserved, Lady Ingram had obtained by covenant any additional benefits... they would have been benefits reserved.

Having had to concede the point that something had been reserved by

Mrs Kamhi, the appellants retreated to their only remaining ground, contending that whatever had been reserved was not, in fact, a benefit.

Their first argument here was that, while Mrs Kamhi was in occupation of the property, she was liable to the landlord under certain covenants. All she did when creating the underlease was to give the right of occupation to Ovalap subject to the same covenants. The legislation must be read purposively: read literally it would mean that no such gifts could ever be made without a reservation. Neither tier of the Tribunal saw much force in this argument. Dismissing the 'purposive interpretation' argument first, Proudman J in the Upper Tribunal held that:

> The argument is to some extent circular in that the question under consideration is whether such a gift can be fiscally effective. It does not assist to start from the premise that it must be.

Having dismissed this, she then linked the argument to the main point of principle. Under the headlease Mrs Kamhi had obligations to the landlord, and the effect of Ovalap's covenant effectively relieved her of the burden of those obligations:

> Mrs Kamhi could and did, under the terms of the underlease, pass her liability to the trustee who was in effect underwriting her liability.

The appellants then submitted that performing the covenants in the underlease was primarily for Ovalap's benefit because by doing so it could enjoy the benefits of the lease without risk of forfeiture. Proudman J responded that this proceeded on a 'false premise'; Mrs Kamhi could just as easily have taken on the burden of performing the covenants.

A number of other arguments were advanced and I will deal with only one of them, which may be of some practical interest (we do not know if the other arguments were of practical interest!). Mrs Kamhi's executors argued that the covenants would have been implied into the underlease in any case. Therefore, the gift would have been impossible to make in any other way. This argument derives such force as it has from the principal one, ie that the covenants 'defined' the property given away. The First Tier Tribunal closed its ears to these issues and responded as follows:

> It does not on the plain words of s102 make any difference whether the contractual or lease term, for instance, is express or implied. The question is whether there is a benefit.

(The Upper Tribunal similarly did not feel the need to comment on this hypothetical point as, in fact, express covenants existed).

Mrs Kamhi's executors' appeal therefore failed. However, if Mrs Kamhi had not been required by her landlord to obtain covenants from the tenant, and therefore been able to grant Ovalap a covenant-free underlease, it seems that the underlease would have achieved its intended purpose.

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Alternative approaches

In view of the landlord's requirement that Mrs Kamhi include covenants in the underlease, would Mrs Kamhi have been better advised to give away a future interest in her existing lease, perhaps by granting her sons' trustee an option to take an assignment of the lease in ten years' time? We might distinguish between two types of reversionary lease schemes: first, those where the owner of a superior interest (freehold or leasehold) grants a lesser interest, the term of which will commence in the future (a '*Buzzoni* scheme'); and, second, those where the donor gives away a future entitlement to an existing interest.

The scope for '*Buzzoni* schemes' will be limited because, where the intending donor is already in a commercial relationship with their landlord, they will have to procure their landlord's consent to the grant of an underlease without any reserved covenants. In principle, provided the donor gives the landlord sufficient comfort, there is no reason why the landlord should not consent to a grant on these terms, but in practice it may of course prove difficult. If the original set up is more 'friendly', and thus a *Buzzoni* scheme is an option, the case makes it clear that the tenant of the reversionary lease must owe no obligations at all to the donor. Whether those obligations are implied or explicit is irrelevant, and so anyone intending to implement the scheme will have to be particularly watchful.

Of course, even if a *Buzzoni* scheme were implemented and managed to avoid the reserved covenants pitfall, it would immediately raise the much-debated question of whether reversionary lease schemes (of any kind) are effective for inheritance tax purposes at all. There is a good argument that they remain effective because the donor's continued occupation of the property is by virtue of their existing interest. HMRC, however, maintains in its Manual that the donor's occupation is a 'significant right in relation to the land' under section 102A, and many practitioners shy away from reversionary lease schemes as a consequence. Finally, even supposing one could surmount all these various hurdles, it seems that the arrangement would be subject to pre-owned assets tax. ■

Buzzoni v HMRCC
[2013] WTLR 47

Ingram v Commissioners of Inland Revenue
[2000] 1 AC 293

Oakes v Commissioner of Stamp Duties New South Wales
[1954] AC 57