[2016] UKFTT 59 (TC)

TC04858

Appeal number: TC/2014/04688

INHERITANCE TAX – deceased granted reversionary sub-lease to sons out of her head leasehold interest – licence to sub-let given by head landlord to deceased – sub-lease provided for same covenants, including repairing covenants, as in head lease – whether property disposed of by way of gift was subject to a reservation under s 102 FA 1986 – application of second limb of s 102(1)(b) – identification of donated property – whether benefit "trenched upon" donees' enjoyment of the donated property - Buzzoni considered

FIRST-TIER TRIBUNAL
TAX CHAMBER

VISCOUNT HOOD
EXECUTOR OF THE ESTATE OF LADY DIANA HOOD **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE ROGER BERNER

Sitting in public at The Royal Courts of Justice, Strand, London WC2 on 12 and 13 January 2016

Simon Taube QC, instructed by Penningtons Manches LLP, for the Appellant

Jonathan Davey, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

1. The estate of the late Lady Diana Hood appeals against a determination of HMRC dated 13 June 2014 in respect of a deemed transfer of value for the purposes of inheritance tax ("IHT") on the death of Lady Hood on 15 March 2008.

2. The notice of determination related to the grant on 19 June 1997 by Lady Hood to her three sons of a sub-lease ("the Sub-Lease") of premises at 67 and 67a Chelsea Square, London SW3 ("the property"). That Sub-Lease was granted out of a lease ("the Head Lease") dated 21 September 1979 of which Lady Hood was the lessee.

3. The determination was as follows:

> A. [H]aving regard to the provisions of section 102 Finance Act 1986 the creation of the Sub-Lease was a disposal by way of gift by the Deceased of property subject to a reservation which falls to be treated as property to which she was beneficially entitled immediately before her death.
>
> B. As transferee and executor you are liable for inheritance tax on the property subject to the reservation having regard to s.200(1)(a) and s.200(1)(c) of the Inheritance Tax Act 1984.

The facts

4. Although I heard some witness evidence, to which I shall refer below, there was essentially no dispute as to the facts.

5. At her death Lady Hood was entitled to the Head Lease of the property. That lease was, as I have referred above, dated 21 September 1979 and was made between (i) Viscount Chelsea ("the head lessor"), (ii) the Chelsea Land & Investment Company Limited, ("Chelsea Land"), (iii) Cadogan Holdings Company ("Cadogan") and (iv) Lady Hood. It was for a term expiring on 25 December 2076.

6. The Head Lease contained unexceptional provisions and covenants, including to pay rent and to repair. In relation to assignment and sub-letting the Head Lease included a covenant by the lessee (clause 2(18)):

> "(a) NOT to assign transfer underlet or part with possession of part only of the demised premises
>
> (b) NOT without the previous consent in writing of the Company [Cadogan] such consent not to be unreasonably withheld to assign transfer or part with possession of the demised premises as a whole (except by way of mortgage or charge) …"

7. The Head Lease also included a right for the lessor to forfeit the Head Lease in the following terms (clause 4(B)):

> "If the rent hereby reserved or any part thereof shall be unpaid for twenty one days after becoming payable (whether formally demanded

> or not) or if any covenant on the Lessee's part herein contained shall not be performed or observed it shall be lawful for the Lessor or the Company at any time thereafter to re-enter upon the demised premises or any part thereof in the name of the whole and thereupon this demise shall absolutely determine but without prejudice to the right of action of the Lessor or the Company in respect of any breach of the Lessee's covenants herein contained."

8. On 17 June 1997 Cadogan granted a written licence to Lady Hood to enter into a reversionary sub-lease of the property. I had witness evidence in relation to the grant of this licence from Miss Catriona Smith who is now a consultant with Penningtons Manches LLP and who at the material time, when working for a predecessor firm, Penningtons, acted for Lady Hood in the obtaining of the licence, and from Mr Damian Greenish, chairman and a member of Pemberton Greenish LLP, who was acting for the Cadogan estate.

9. Application for licence to sub-let was made by Miss Smith on behalf of Lady Hood by letter dated 14 May 1997. Miss Smith was concerned to avoid protracted correspondence on the matter, and accordingly sent with that letter a draft of the proposed Sub-Lease, which included provision that the sub-lessees would covenant with the lessee in identical terms to the Head Lease. The letter sought expedition, it being explained that there was a possibility of the introduction of changes to tax legislation.

10. Mr Greenish sought instructions from Cadogan, and sent them a copy of the draft Sub-Lease. Cadogan replied to Mr Greenish on 12 June 1997, enclosing a pro forma relating to the estate's consent to a sub-lease to Lady Hood's three sons. That pro forma set out, amongst other things, a short description of the property, the names and addresses of the proposed sub-lessees and the fact that the rent and rent review provisions were to mirror those in the Head Lease. Neither the letter from Cadogan nor the pro forma referred to the draft Sub-Lease.

11. On 13 June 1997 Mr Greenish wrote to Penningtons enclosing a draft licence. That draft was approved, and the licence was entered into on 17 June 1997. Its parties were (i) Cadogan and (ii) Lady Hood. The proposed sub-lessees were not party to the licence, and gave no direct covenants to the head lessor or Cadogan. No such covenants were required under the terms of the Head Lease.

12. Under the licence, Cadogan for itself and as agent for the head lessor and Chelsea Land granted licence to sub-let according to the terms in the Second Schedule to the licence. That schedule referred only to the property, the proposed sub-lessees, the term (from 25 March 2012 to 22 December 2076) and the rent. The draft Sub-Lease was not appended, nor was it referred to in the licence.

13. Mr Greenish confirmed in his oral evidence, and I find, that at no stage in the process of Cadogan considering and agreeing to grant the licence was Cadogan asked what its position would have been if the terms of the sub-lease that was granted had been different from the draft presented to it.

14. The Sub-Lease was granted on 19 June 1997. By it the property was sub-let for a term of years commencing on 25 March 2012 and expiring on 22 December 2076. The Sub-Lease was made upon and subject to the same terms, covenants, provisos and conditions as were contained in the Head Lease. Lady Hood, as sub-lessor, and her sons, as sub-lessees, respectively covenanted to perform and observe those provisions (varied only as necessary to make them apply to the demise under the Sub-Lease) as if they had been repeated in the Sub-Lease.

15. The relevant terms of the Sub-Lease were as follows:

> "4. **Terms of Lease**
>
> 4.1 This Lease is made upon the same terms and subject to the same covenants provisos and conditions as are contained in the Head Lease ('the Head Lease Provisions') except as to the rent and term of years granted and as varied by the remaining provisions of this lease so that this Lease shall be construed and take effect as if the Head Lease Provisions as varied were repeated in this Lease in full with such modifications only as are necessary to make them apply to this demise.
>
> 4.2 To the extent that the Head Lease Provisions are inconsistent with this Lease the provisions of this Lease shall apply.
>
> 5. **Mutual Covenants**
>
> The Landlord and the Tenant mutually covenant that they will respectively perform and observe the Head Lease provisions as varied as if they had been repeated in full in this Lease."

The IHT legislation

16. The notice of determination was made by reference to s 102 of the Finance Act 1986 ("FA 1986") which, so far as is material, provides as follows:

> "(1) Subject to subsections (5) and (6) below, this section applies where, on or after 18th 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 at or before the beginning of the relevant period; or
>
> (b) at any time in the relevant period 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;
>
> and in this section "the relevant period" means a period ending on the date of the donor's death and beginning seven years before that date or, if it is later, on the date of the gift.
>
> (2) If and so long as—
>
> (a) possession and enjoyment of any property is not bona fide assumed as mentioned in subsection (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.

5 (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, to the extent that the property would not, apart from this section, form part of the donor's estate immediately before his death, that property shall be treated for the purposes of the 1984 Act as property to 10 which he was beneficially entitled immediately before his death.

(4) If, at a time before the end of the relevant period, any property ceases to be property subject to a reservation, the donor shall be treated for the purposes of the 1984 Act as having at that time made a disposition of the property by a disposition which is a potentially 15 exempt transfer."

17. Section 102 FA 1986 is part of the overall scheme of IHT. The principal Act in relation to IHT is the Inheritance Tax Act 1984 ("IHTA"). Section 114(5) FA 1986 provides that Part V of that Act, which includes s 102, is to be construed as one with the IHTA.

20 18. IHT is charged on the value transferred by a chargeable transfer (s 1, IHTA). A chargeable transfer is a transfer of value which is made by an individual but which is not an exempt transfer (s 2). Subject to the provisions of the IHTA, a transfer of value is a disposition made by a person as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition, and 25 the amount by which it is less is the value transferred by the transfer (s 3(1)).

19. On the death of any person, IHT is charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death (s 4(1)). References in the IHTA to a transfer of value include such deemed transfers of value on death (s 3(4)).

30 20. For the purposes of the IHTA, a person's estate is the aggregate of all the property to which he is beneficially entitled, except that the estate of a person immediately before his death does not include excluded property (s 5(1)). In determining the value of a person's estate at any time his liabilities shall be taken into account except as otherwise provided by the IHTA (s 5(3)). A liability in respect of 35 which there is a right to reimbursement shall be taken into account only to the extent (if any) that reimbursement cannot reasonably be expected to be obtained (s 162(1)).

21. The effect of s 102 FA 1986 is that the estate of a person immediately before his death is deemed to include additional property, which would not otherwise form part of his estate for IHT purposes, if it amounts to "property subject to a reservation" as 40 that term is defined in s 102.

22. Section 102 was originally enacted at the same time as the IHT legislation introduced the concept of the potentially exempt transfer of value ("PET"). Broadly, a PET is a lifetime transfer of value by an individual, which is initially assumed to be

an exempt transfer. It will be an exempt transfer only if, in the events which happen, it is made seven years or more before the death of the transferor. Any other PET is a chargeable transfer (s 3A IHTA, inserted by FA 1986, Sch 19, para 1). So far as is material, s 3A provides:

5 "(1) Any reference in this Act to a potentially exempt transfer is a reference to a transfer of value—

(a) which is made by an individual on or after 18th March …; and

(b) which, apart from this section, would be a chargeable transfer (or to the extent to which, apart from this section, it would be such a
10 transfer); and

(c) to the extent that it constitutes either a gift to another individual or a gift into an accumulation and maintenance trust or a disabled trust;

…

15 (2) … a transfer of value falls within subsection (1)(c) … above, as a gift to another individual,—

(a) to the extent that the value transferred is attributable to property which, by virtue of the transfer, becomes comprised in the estate of that other individual, or

20 (b) so far as that value is not attributable to property which becomes comprised in the estate of another person, to the extent that, by virtue of the transfer, the estate of that other individual is increased."

Issues in this appeal

25 23. The dispute in this case concerns s 102(1)(b) FA 1986. There is no dispute that the grant of the Sub-Lease was a disposal of property, nor that it was a disposal by way of gift within s 102. Nor is there any argument that the first limb of s 102(1)(b) – that at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor – applies in this case. The
30 dispute is confined to the second limb of that provision, which can be expressed as: at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of any benefit to the donor by contract or otherwise. It is further confined by there being no argument in relation to the relevant period.

24. As submitted by Mr Davey, HMRC's case on the second limb of s 102(1)(b) is
35 simple. It is submitted that the Sub-Lease cannot be said to be property enjoyed to the entire exclusion of "any benefit" to Lady Hood, as the donor, because Lady Hood plainly did obtain a benefit, namely the sub-lessees' covenants in the Sub-Lease to observe certain of the provisions of the Head Lease as modified so as to form part of the Sub-Lease. Lady Hood, it is argued, was in effect provided with an indemnity
40 from the sub-lessees for the performance of her covenants as lessee under the Head Lease. Thus, it is submitted, the case falls within the scope of the second limb of s 102(1)(b), and the Sub-Lease constitutes property subject to a reservation.

25. The Appellant's case, as put by Mr Taube, is that the sub-lessees did enjoy the donated property – the sub-leasehold proprietary interest – to the entire exclusion, or virtually to the entire exclusion, of any benefit to Lady Hood by contract or otherwise, and that accordingly s 102 FA 1986 is inapplicable. Four reasons are given, which can be summarised as follows:

(1) HMRC's analysis fails to identify accurately the "property" comprised in Lady Hood's "gift". The donated property was not the legal instrument (namely the Sub-Lease) by which Lady Hood made her gift. The donated property comprised the sub-leasehold proprietary interest that was defined by a mixture or bundle of rights and obligations, including the sub-lessees' covenants: the donated property was not the sub-leasehold interest free of the sub-lessees' covenants, and so the sub-lessees never acquired or were able to enjoy an interest in an asset that was free of the burden of such covenants.

(2) The benefit of the sub-lessees' covenants enjoyed by Lady Hood did not "impact upon" or "trench upon", and was not "at the expense of" the donees' enjoyment of the donated property. On the true construction of s 102(1)(b), as interpreted by the Court of Appeal in *Buzzoni v Revenue and Customs Commissioners* [2014] 1 WLR 3040 (CA); [2013] EWCA Civ 1684, this benefit was outside the scope and mischief of s 102(1)(b).

(3) As a matter of property law, the benefit of the sub-lessees' covenants formed part of Lady Hood's retained proprietary interest under the Head Lease, not the donated property. Lady Hood was therefore not enjoying any part of the donated property, and the case is outside s 102(1)(b).

(4) On Lady Hood's death the value of her right to the benefit of the sub-lessees' covenants in the Sub-Lease was already chargeable to IHT. The scheme of the IHT legislation indicates that there is no mischief or other good policy reason why, on Lady Hood's death, the benefit of such covenants should also trigger an extra charge under s 102 on the value of the Sub-Lease.

Discussion

26. Because it is a case on similar, though not identical, facts, it is convenient to start with *Buzzoni* in the Court of Appeal. In that case, the donor was the lessee under a head lease and granted a sub-lease to the nominee of the trustee of a settlement trust which she had created in favour of her two sons, retaining the reversion to the sub-lease when it expired. The sub-lease was rent-free, but included certain covenants such as for the payment of the service charge payable under the head lease and for repair and redecoration. In accordance with the terms of the head lease, the sub-lease was granted with the consent of the head lessor by licence to sub-let to which the sub-lessee was party and by which the sub-lessee covenanted directly with the head lessor to observe and perform the covenants and conditions, other than rent, contained in the head lease.

27. The First-tier Tribunal and the Upper Tribunal had dismissed the taxpayer's appeals. But the Court of Appeal allowed the appeal to it. It held that, in construing s 102(1)(b) FA 1986, the focus was not primarily on the question whether the donor

had obtained a benefit from the gifted property, but whether the donees' enjoyment of that property remained exclusive. If the benefit to the donor had no impact on, was irrelevant to and made no or virtually no difference to the donees' enjoyment, the donees' enjoyment was to the entire or virtually entire exclusion of any benefit to the donor. On the facts of *Buzzoni*, any benefit which the donor had obtained from the positive covenants did not affect or make any difference to the donees' enjoyment of the sub-lease; the donees' obligations under those covenants precisely matched the obligations which they already owed to the head lessor under the licence to sub-let. Even if the donor could be said to have obtained a benefit which she had not previously enjoyed, it had not been obtained at the expense of the donees' enjoyment of the sub-lease and had neither added to nor subtracted from that enjoyment.

28. Accordingly the Court (Moses LJ, with whom Black and Gloster LJJ agreed) held that, even if the donor had enjoyed the benefit of the positive covenants by virtue of the sub-lease, the sub-lease in that case did not constitute property "subject to a reservation" within the meaning of s 102(2) FA 1986 and was not to be treated for the purposes of IHT as property to which she had been beneficially entitled immediately before her death.

29. On that basis, the taxpayer in *Buzzoni* succeeded even if it were the case that the benefit derived from the sub-lease. It was immaterial whether, as had been the focus of dispute in *Buzzoni*, the positive covenants given by the sub-lessees were themselves part of the proprietary interest retained by the donor or part of the interest of which she made a gift. Thus, given the *ratio* of the judgment, it was not necessary to decide what amounted to the "donated property" for the purpose of s 102. Whatever the nature of that property, the enjoyment of it by the donees had not been "trenched upon" by the giving of positive covenants to the donor, because the donees had the burden of those covenants by virtue of the obligations they owed already to the head lessor under the licence to sub-let.

The "trenching" argument

30. The same "trenching" argument forms the second of Mr Taube's four principal submissions in this case. In light of the *ratio* in *Buzzoni*, which binds this Tribunal, I consider that element of his submissions first.

31. Lord Justice Moses addressed this issue at [30] to [57] of his judgment. He rejected the argument for HMRC that once it was concluded that the benefit was derived from the gift, that was the end of the inquiry. But having considered a number of authorities relied upon by the taxpayer, in particular *St Aubyn v Attorney General* [1952] AC 15, Moses LJ found, at [49], that those authorities did not carry the taxpayers in *Buzzoni* as far as they wished to go. Although those authorities showed that it may not be sufficient to ask whether the donor has received a benefit and that the inquiry must go further and ask whether the benefit is derived from the property comprised in the gift or from property which was not so comprised, they did not turn on any further inquiry as to whether, even if it was derived from the gifted property, the benefit was at the cost or expense or to the detriment of the donee's enjoyment.

32. Instead, at [50], Moses LJ found that there was sufficient support for the taxpayers' contention in the wording of s 102(1)(b) itself. Although to come within the second limb of s 102(1)(b) it was a necessary condition that the benefit must consist of some advantage which the donor did not enjoy before he made the gift (see *Ingram v IRC* [1997] 4 All ER 395, in the Court of Appeal per Millett LJ at p 435, and the reference of Lord Hoffmann in the House of Lords [2000] 1 AC 293, at p 304, to "additional benefits" obtained by covenant (as in *Re Nichols, decd* [1975] 1 WLR 534) being benefits reserved), that was not in all cases a sufficient condition (Moses LJ, at [51]).

33. In *Buzzoni*, at [53], Moses LJ referred to the policy of s 102(1)(b) identified by Lord Hoffmann in *Ingram*, at p 305:

> "What, then, is the policy of section 102? It requires people to define precisely the interests which they are giving away and the interests, if any, which they are retaining. Once they have given away an interest they may not receive back any benefits from that interest. In *Lang v. Webb*, 13 C.L.R. 503, 513 Isaacs J. suggested that the policy was to avoid the 'delay, expense and uncertainty' of requiring the revenue to investigate whether a gift was genuine or pretended. It laid down a rule that if the donor continued to derive any benefit from the property in which an interest had been given, it would be treated as a pretended gift unless the benefit could be shown to be referable to a specific proprietary interest which he had retained. This is probably the most plausible explanation and accepting this as the policy, I think there can be no doubt that the interest retained by Lady Ingram was a proprietary interest defined with the necessary precision."

34. Lord Justice Moses held, at [55], that an inquiry into the extent to which the donor's benefit affects the exclusivity of the donee's enjoyment did not offend the principle in *Lang v Webb*. The statutory criterion *is* the exclusivity of enjoyment of the gifted property. If the donor's benefit makes no difference to the donee's enjoyment of that property, it is not possible to say that the donee's enjoyment was other than to the exclusion of any benefit to the donor.

35. At [56], Moses LJ stated his conclusion:

> "Accordingly, I consider it is necessary to inquire whether the benefit the deceased obtained from the positive covenants affected Legis's enjoyment of the flat. In my view, it made no difference whatsoever to the underlessees' enjoyment of the underlease. The underlessees were already under obligations, in the licence to underlet, to the head lessor which precisely matched those obligations into which they entered with the deceased (save that the underlessees were under no obligation to pay rent). The obligations in the positive covenants did not in any way detract from the enjoyment of the underlease because the obligations imposed by those covenants did not in any way add to the obligations already imposed by the licence. It is true they were entered into with a different party, but performance of one set of obligations, for example, those contained in the licence, would have fulfilled the obligations in the positive covenants in the underlease and vice versa.

> Even if it may be said that the deceased obtained a benefit she had not previously enjoyed, it was not obtained at the expense of the donees' enjoyment of the underlease. It neither added to nor subtracted from their enjoyment in the light of the obligations into which they had already entered with the head landlord."

36. In the Appellant's grounds of appeal it was submitted, in support of the trenching argument, that "as a matter of fact, the Cadogan estate would not have permitted [Lady Hood] to grant the reversionary underlease without the sub-tenants' covenants contained there". Mr Taube accepted, however, that the evidence did not support that assertion of fact. That particular submission was therefore abandoned.

37. As a matter of fact, the sub-lessees were not party to the licence and, in contrast to the position in *Buzzoni*, the sub-lessees gave no direct covenants to the head lessor. The only positive covenants from the sub-lessees were those given in the Sub-Lease in favour of the sub-lessor, that is Lady Hood.

38. It was not open to Mr Taube to argue that in this case the sub-lessees were, irrespective of the positive covenants given by them to Lady Hood under the Sub-Lease, bound either directly to the head lessor or to indemnify Lady Hood for any breaches of the tenant's covenants in the Head Lease. Unlike the position in Buzzoni, the sub-lessees were under no obligation to the head lessor with respect to those covenants. The principle in Moule v Garrett (1872) LR 7 Ex 101, to which Moses LJ referred in Buzzoni, at [32], does not apply in the circumstances of this case, as there is no commonality of obligation of the sub-lessor and the sub-lessees to the head lessor.

39. Mr Taube argued instead that the circumstances of this case were economically equivalent to those in *Buzzoni*. This submission was founded upon the implied obligation of the sub-lessors to deliver up the property at the expiry of the Sub-Lease, by virtue of *Henderson v Squire* (1869) LR 4 QB 170. In order to do so, it was argued, the sub-lessees would be required to avoid a forfeiture of the Sub-Lease, and to do so would have to ensure that the covenants contained in the Head Lease were performed. Mr Taube argued that these obligations would have arisen if the Sub-Lease had been a bare lease, with no positive covenants mirroring those in the Head Lease. The sub-leasehold interest of the sub-lessees was accordingly trenched upon by those obligations, which the positive covenants in favour of Lady Hood did no more than duplicate.

40. Mr Taube derived support for this economic equivalence argument from the speech of Lord Hoffmann in *Ingram*. In that case the owner of certain property conveyed the fee simple of the whole property to her solicitor as her nominee. The solicitor granted her two leases for different parts of the property, rent free and with no covenants except the covenant for quiet enjoyment. Subsequently, the property was conveyed, subject to the leases, to trustees to hold on trust for the donor's children and grandchildren. One question was as to the validity of the initial transfer to the nominee. But the House of Lords also considered whether s 102 FA 1986 applied on the assumption that the initial transfer was invalid.

41. It was in that context that Lord Hoffmann (with whom three of the four other law lords agreed; Lord Hutton delivered a concurring judgment) considered the earlier decision of the Court of Appeal in *Nichols*, where the Court, at p 543, had expressed the view, but without reaching a final conclusion on the point, that the grant of a fee simple, subject to and with the benefit of a lease back was the grant of the whole fee simple with something reserved out of it, and not a gift of a partial interest leaving something in the hands of the grantor which he has not given. Lord Hoffmann disagreed with the view expressed by the Court of Appeal in *Nichols*. He emphasised the need to look to the reality and not the mere conveyancing form of the transaction and said, at pp 303-304:

> "… section 102 is concerned not with conveyancing but with beneficial interests. It uses words like 'enjoyment' and 'benefit.' In *Attorney-General v. Worrall* [1895] 1 Q.B. 99, 104, a case on a predecessor of section 102, Lord Esher M.R. began his judgment with the words: 'It has been held that in cases of this kind the court has to determine what the real nature of the transaction was, apart from legal phraseology and the forms of conveyancing.' If one looks at the real nature of the transaction, there seems to me no doubt that Ferris J. was right in saying that the trustees and beneficiaries never at any time acquired the land free of Lady Ingram's leasehold interest. The need for a conveyance to be followed by a lease back is a mere matter of conveyancing form. As I have said, she could have reserved a life interest by a unilateral disposition. Why should it make a difference that the reservation of a term of years happens to require the participation of another party if the substance of the matter is that the property will pass only subject to the lease? Mr. Nugee and Mr. Furness, on behalf of the commissioners, each explained patiently and clearly that the great difference was that 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. This is true and if, in addition to the leasehold estate which she reserved, Lady Ingram had obtained by covenant any additional benefits, as in *In re Nichols, decd.* [1975] 1 W.L.R. 534, they would have been benefits reserved. But in a case such as this, when she in fact received no such benefits, the contractual nature of the lease seems to me a matter of conveyancing theory rather than substance."

42. Although it is clear that regard must be had to substance and not to conveyancing form, I do not accept that the substance of this case is economically equivalent to that in *Buzzoni* such that the sub-lessee's enjoyment of the sub-leasehold interest they acquired must be regarded as subject to equivalent obligations to those owed by the underlessees in *Buzzoni*. There is, in my judgment, a world of difference between obligations to which a sub-lessee might be subject by way of direct covenant to a head lessor, and the actions that might have to be taken in practice by a sub-lessee to avoid or obtain relief from forfeiture in the event that the lessee failed to observe covenants in the head lease, and the head lessor took steps to forfeit the head lease.

43. The question is whether, to the extent that the benefit of the positive covenants in the Sub-Lease was retained out of the donated property (which I consider below),

the enjoyment of the donated property was, prior to the grant of the Sub-Lease and the giving thereby of the positive covenants, already subject to obligations the performance of which would fulfil those under the positive covenants. The enjoyment of the property must, as Moses LJ described in *Buzzoni* at [57], already be subject to obligations which mirror or duplicate those contained in the positive covenants. I agree with Mr Davey that this is not a matter of conveyancing machinery. The substance of the position in this case is different from that in *Buzzoni*, and the economic equivalence argument must accordingly fail.

44. Although Mr Taube sought to support his argument by reference to a number of examples based on different facts to those in this case, I have not found those of assistance in determining the question which must be answered by reference to the facts of this case itself. Mr Taube relied upon *St Aubyn* for the proposition that contractual benefits received by the donor, none of which had existed before the transactions were entered into, had been held by the House of Lords not to constitute a benefit. He referred also to *Oakes v Commissioner of Stamp Duties of New South Wales* [1954] AC 57, where the argument of the tax authority that a settlor had obtained a benefit from income from shares settled on his children because it relieved him from the cost of their maintenance was rejected on the basis that the advantage to the settlor did not impair or diminish the value of the gift. Those arguments were considered by Moses LJ in *Buzzoni*, and were held not to be decisive. It is the wording of s 102(1)(b) which is in point. By reference to that wording, and to the judgment of the Court of Appeal in *Buzzoni*, I find that, to the extent that the benefit of the positive covenants in the Sub-Lease was derived from the donated property in this case, the enjoyment of the sub-lessees was not to the exclusion of any benefit to Lady Hood.

45. It follows therefore that the Appellant's trenching argument fails.

The "donated property" argument

46. In view of the unanimous judgment of the Court of Appeal in *Buzzoni* in favour of the taxpayers on the trenching argument, no conclusion was reached on the question of the nature of the donated property in that case, namely whether it was the sub-leasehold interest, out of which the benefit of the positive covenants was reserved, or an interest already shorn of Lady Hood's interest in those covenants. The short judgments of Black LJ and Gloster LJ, agreeing with Moses LJ on the trenching question, indicate that they did not propose to address the question whether the benefit of the positive covenants in the sub-lease in that case derived from the interest retained by the deceased when she made the gift or from the property which she had given to the donees.

47. That question was, on the other hand, addressed at some length by Moses LJ. Although not part of the *ratio* of the judgment in *Buzzoni*, it is nonetheless persuasive.

48. Lord Justice Moses began by considering the source of what he described as "the impugned benefit". He noted, at [17], referring to what Lord Hoffmann had said in *Ingram* (at p 300), that the two proprietary interests, namely the donees' sub-lease

and the donor's reversionary interest, existed simultaneously. The proprietary interest that was never gifted was the reversion to the sub-lease. Following *Ingram*, there could be no argument that the reversion was itself a reservation out of the subject matter of the gift. The dispute was whether the positive covenants in the sub-lease were themselves part of the proprietary interest retained by the deceased or part of the interest of which she made a gift.

49. Lord Justice Moses concluded, at [29], that the rights conferred by the covenants were obtained by virtue of the sub-lease, the subject of the gift, and not by virtue of the reversion the deceased retained. His reasoning can be summarised as follows:

(1) The issue whether the covenants were part of the proprietary estate retained or that gifted emerged from the decision of the House of Lords in *Ingram* (*Buzzoni*, at [19]).

(2) In *Ingram*, the reality was that the gift to the trustees and to the beneficiaries was never free of the leasehold interest retained by the donor. However, that was only a starting point. There was a crucial distinction between *Ingram* and *Buzzoni*. Whereas in *Ingram* the donor obtained no covenant other than a covenant of quiet enjoyment, which was (per Lord Hoffmann in *Ingram*, at p 303), in *Buzzoni* the donor obtained positive covenants (at [20] – [22]).

(3) It was an undisputed proposition that leasehold covenants of the nature of the positive covenants may bind and benefit third parties. The benefit of the covenants would pass to any successor in title to the donor's proprietary interest. Lord Justice Moses accepted that the benefit of the covenants became attached to the proprietary interest the deceased retained in the head lease, and that the covenants took on a proprietary character. But he rejected the argument that the benefit was derived from the retained, rather than the gifted, interest (at [24]).

(4) In contrast to the position in *Buzzoni*, Lady Ingram had received no advantage which she did not enjoy before she made the gift. As Millett LJ had described the position in *Ingram* in the Court of Appeal, at p 435: "The lease itself was merely property not comprised in the gift. It contained no covenants which would have the effect of transferring to the trustees a liability which would otherwise be borne by Lady Ingram." But the position would have been different if Lady Ingram had received additional benefits. As Lord Hoffman said at p 304, in the passage I have cited at [41] above, if Lady Ingram had obtained by covenant any additional benefits, as in *Nichols*, they would have been benefits reserved (at [24] – [25]).

(5) The consideration by the Court of Appeal in *Nichols* of the full repairing covenant, at p 543, is good law:

> "The right to have the mansion house and outbuildings repaired under that covenant did not exist before, and therefore could not be something simply not given … it was reserved out of that which was

given, since it was a covenant immediately operative and running with the land."

(*Buzzoni*, at [26])

(6) The deceased had, apart from the positive covenants, no right to impose a liability on the sub-lessees to keep the property properly decorated and to redecorate every fifth year. That the positive covenants may, in the particular circumstances of the *Buzzoni* case, have been unnecessary did not assist the question whether they derived from the gift rather that from the interest retained. The references by Millett LJ and Lord Hoffmann in *Ingram* to the absence of covenants in that case demonstrated that the benefit of the positive covenants was enjoyed by the deceased by virtue of the sub-lease of which she made a gift and not by virtue of the reversion she retained (at [27]).

(7) The argument for the taxpayer that the sequence of events, including first the licence to sub-let under which the sub-lessees covenanted directly with the head lessor to observe the tenant's covenants in the head lease, secondly the grant of the sub-lease to the sub-lessee under which the sub-lessee entered into the positive covenants with the deceased, and thirdly a gift when the sub-lease was settled on the trustee for the benefit of the deceased's sons, had the effect that the benefit of the covenants was already part of the reversion prior to the gift of the sub-lease was rejected. Looking at the reality, the covenants conferred rights on the deceased which arose from the obligations imposed in the sub-lease. As Moses LJ said (at [29]):

> "The fact that the benefit of those covenants, once obtained, formed part of the deceased's proprietary interest and could therefore be passed to third parties on assignment, just as the burden of the obligations was part of the underlease and could be imposed on any assignee of the underlease (had that been permitted), tells one nothing as to the source of that benefit and burden. The benefit Sir Peter Nichols obtained from the trustees in the form of the covenant to repair became attached to and part of his leasehold interest. But, even though his leasehold was not, on the analysis of Walton J in *In re Nichols, decd* [1974] 1 WLR 296 and *Ingram's* case [2000] 1 AC 293, received back from the freehold of which he made a gift, the benefit of the covenant to repair was a reservation from that gift and not comprised in the leasehold retained. Sir Peter Nichols was not able to overcome the conclusion that the covenant to repair was a reservation from the gift by any argument that the covenant to repair 'partook of the nature' of his leasehold estate. Millett LJ's and Lord Hoffmann's reference to the absence of any covenant by which additional benefits are obtained [1997] 4 All ER 395, 435; [2000] 1 AC 293, 304C scotches the taxpayers' argument on this point. I conclude that the rights conferred by the covenants were obtained by virtue of the underlease, the subject of the gift, and not by virtue of the reversion the deceased retained."

50. Faced with this reasoning, Mr Taube sought to argue, first, that the property disposed of by way of gift which is required to be identified for the purposes of s 102 FA 1986 was not the Sub-Lease. That, it was submitted, was merely the legal instrument of disposition by which Lady Hood made her gift. Mr Taube argued that

the donated property was the mixture of rights and obligations taken by the sons, as sub-lessees, which formed the subject of their sub-leasehold proprietary interest. The sub-lessees' covenants had no separate existence from the sub-leasehold interest. Accordingly, argued Mr Taube, the covenants could not be "derived" from that interest. At no time were the sons, as sub-lessees, entitled to any proprietary interest in the property free from the obligations or covenants in the Sub-Lease.

51. Mr Taube's argument emphasised what he submitted were the legal nature and effect of the Head Lease and the Sub-Lease. The proprietary interest of the lessee, on the one hand, and the sub-lessee on the other were, he submitted, defined by the benefits and burdens of the covenants in the Head Lease and Sub-Lease. The sub-leasehold proprietary interest of the sub-lessees was not a mere right or benefit or bare estate free of the obligations to perform the covenants. Instead the donated property represented by the sub-leasehold interest comprised a bundle of rights and obligations in the hands of the donees. The interest of a sub-lessee was always defined by and subject to the burden of the covenants in the head lease and the sub-lease; if the covenants in the head lease are not performed, the head landlord can forfeit the lease. If a sub-lessee is to obtain relief from forfeiture, that will usually require the performance of equivalent covenants to those in the head lease.

52. Mr Taube's second argument, which in some respects is the other side of the coin to the first, is that Lady Hood's right to the benefit of the sub-lessees' covenants was referable to her retained head leasehold proprietary interest, and accordingly was outside s 102(1) FA 1986. This, essentially, is the argument which failed to persuade Moses LJ in *Buzzoni*. Mr Taube submitted that the observations of Moses LJ in this regard, which were in the event *obiter*, are flawed for three reasons.

53. As to the first reason, Mr Taube submitted that Moses LJ wrongly confused the legal instrument by which a donor disposes of property with the donated property itself. He referred to the description by Moses LJ in *Buzzoni* at [27] and [29] to the benefit of the positive covenants being enjoyed by the deceased "by virtue of the underlease of which she made a gift" and not by virtue of the reversion which she retained, and to the covenants being "obtained by virtue of the underlease, the subject of the gift, and not by virtue of the reversion …".

54. The second reason submitted is that Moses LJ failed to consider what Mr Taube described as the crucial linked issue of the identity of the donated property, the arguments for which I have set out above.

55. The third reason submitted by Mr Taube was that the reasoning and conclusion of Moses LJ were primarily based on the facts and *dicta* in *Nichols*, and *obiter dicta* in that respect in *Ingram*. It was submitted that in doing so Moses LJ had overlooked the real issues in those cases and the important distinctions between those cases and that in *Buzzoni* and the present case.

56. As Mr Taube pointed out, in each of *Nichols* and *Ingram* the relevant transactions involved a grant to the donor of a long lease of a house and land and a gift by the donor of the freehold subject to and with the benefit of that lease. In

Nichols, the donor imposed on the donee a landlord's covenant to repair the house, which the donor was going to occupy under the lease. Prior to the lease there was no such burden affecting the freehold reversion. Mr Taube submitted that in those circumstances it was not surprising that the Court of Appeal found that, as a result of the donee's covenant, the donated freehold reversion was not enjoyed by the donee to the exclusion of any benefit to the donor. In *Ingram*, there were no relevant covenants benefitting the donor, and so the case fell outside the first limb of s 102(1)(b). The argument was on the first limb; that argument was rejected.

57. By contrast, argued Mr Taube, in the present case Lady Hood held and retained her leasehold interest under the Head Lease both before and after the grant of the Sub-Lease. Although the sub-lessees' covenants were contained in the disposition represented by the instrument of the Sub-Lease, he submitted that the covenants were not derived from the donated property.

58. I am not persuaded by Mr Taube's arguments that I should depart from the conclusion reached by Moses LJ in *Buzzoni*, or the reasoning by which that conclusion was reached.

59. As to Mr Taube's first argument, I can find no reason to doubt that what must be ascertained is what is retained and what is given away. Where parallel proprietary interests exist in property simultaneously, as they do when a sub-leasehold interest is created out of a head lease, then as Lord Hoffmann said in *Ingram*, at p 300, one such interest may form the subject matter of a gift while the other is retained. It is the proprietary interest which is gifted, carrying with it both benefits and burdens. There is in my view no scope for, and certainly no authority for, the proposition that a proprietary interest gifted by way of a sub-lease must be dissected, and the donated property regarded as being what is left after carving out the burdens on the sub-lessee which are inherent in the sub-lease.

60. It is clear from *Nichols* and *Ingram* that a benefit to a donor which arises from a burden which may be imposed as a condition of a gift is, unless it is retained as part of the interest retained by the donor, so as not to form part of the gift, a benefit referable to the gift, and that it does not cut down the nature of the donated property itself. As the Court of Appeal described the position in *Nichols*, at p 543:

> "The right to have the mansion house and outbuildings repaired under that covenant did not exist before, and therefore could not be something simply not given. Moreover, it was reserved out of that which was given, since it was a covenant immediately operative and running with the land. In any event, however, being a covenant for the benefit of the donor, at the expense of the donee, and one which he was as a condition of the gift obliged to enter into and for the protection and better enjoyment of the property by the donor, it must, in our judgment, be a benefit to the donor by contract or otherwise referable to the gift and so within the section."

61. It is of course the case that the Court of Appeal in *Nichols* was considering a repairing covenant in a lease back to the donor out of the freehold estate which had been given. But in my judgment the principle applies equally to a burden which is

inherent in the proprietary interest which is granted as it applies to burden imposed as a condition to the gift or a burden which the donee is under an equitable obligation to assume.

62. As in *Buzzoni*, Lady Hood granted an interest in land to her sons by way of the Sub-Lease. That lease was, as a matter of contract, subject to the obligations under the positive covenants. Those covenants represented a benefit to Lady Hood. The essential question, which runs through the authorities, is whether that benefit had been retained as part of the proprietary interest retained by the donor, or whether it trenched upon the interest which had been gifted. That is the essence of the test, encapsulated by Millett LJ in *Ingram*, at p 435, that the benefit must consist of some advantage which the donor did not enjoy before he made the gift. To the extent that the benefit had been retained as part of the proprietary interest retained by the donor, then it would not be part of the donated property. But to the extent that it was not, and was a benefit not enjoyed by the donor before the making of the gift, the donated property would comprise everything not so retained by the donor, and any such benefit would be reserved out of the donated property.

63. The donated property is thus the sub-leasehold interest conferred on the sub-lessees by the Sub-Lease. That donated property is subject to the contractual covenants given by the sub-lessees, but it is not defined by them.

64. I do not accept, as argued by Mr Taube, that the scheme of IHT can affect this analysis. It is right that s 102 FA 1986 falls to be construed as one with the IHTA. Section 3A IHTA, which provides for PETs, employs the language of gift, a concept otherwise absent from the general scheme of IHT, which charges tax by reference to actual and deemed transfers of value, and on the value transferred by such transfers. Section 3A(2) accordingly qualifies what is to be regarded as a gift to an individual under s 3A(1)(c) by reference to the value transferred or the increase in value of the estate of the donee.

65. By contrast, no such qualification is introduced into s 102. The reference in that section to a disposal of property by way of gift must therefore be to a gift construed according to its ordinary meaning. The question that must be answered in relation to s 102 is what property has been disposed of by way of gift, not what value has been transferred. Those are different questions, and the inclusion of s 102 in the scheme of IHTA does not assimilate them. Thus the fact that where a transfer of value is made subject to burdens and obligations the charge to IHT is on the value of the donated property subject to the burdens and obligations affecting it (in other words, the value transferred), does not indicate a construction of s 102 by which the donated property must be regarded as something other than the whole proprietary leasehold interest, as represented by the Sub-Lease, with its benefits and burdens.

66. The question remains whether, as Mr Taube has argued, Lady Hood's right to the benefit of the sub-lessees' covenants was referable to the head leasehold interest retained by Lady Hood, so as not to form part of the donated property. It is well settled, following *Ingram*, that s 102 does not operate to prevent a donor from deriving benefit from an object in which he has given away an interest so long as the

donor does not derive benefit from that interest and the benefit can be shown to be referable to a specific proprietary interest which is retained (*Ingram*, per Lord Hoffmann, at p 305). But the essential point is that it must be a benefit which is both referable to the donor's proprietary interest and *retained* by the donor. The fact that benefits may become attached to such a proprietary interest, even where those benefits take on a proprietary character, does not mean that they are retained as such so as not to form part of the donated property.

67. I do not accept that Moses LJ can be said to have confused the legal instrument with the donated property itself. That, it seems to me is nothing more than an exercise in semantics. It is quite clear from the discussion in *Buzzoni* at [17] – [18] that the ways in which the beneficial ownership of land might be divided and the distinction drawn in *Ingram* between property interests in possession and those in remainder or reversion was fully appreciated. Furthermore, there can be no doubt that the distinction between substance and mere conveyancing form was not lost on Moses LJ: that distinction was clearly drawn by Lord Hoffmann in *Ingram* at pp 303-304, to which Moses LJ referred at [25] of his judgment.

68. Nor, for the reasons I have set out above, do I accept Mr Taube's arguments by reference to the identity of the donated property.

69. I do accept that the facts of *Nichols* and *Ingram*, and in the event the essential issue in *Ingram*, were different from those in *Buzzoni*, and different from those in the present case. But those cases cannot, in my judgment, be regarded as confined to their own facts. They establish principles which are applicable beyond their own particular circumstances, and contain helpful guidance on the proper approach to cases of the nature of this case.

70. In *Nichols*, as I have described, there was a gift of a freehold estate and a lease back from the donee to the donor. The lease back included a covenant by the donee to keep the property in good and substantial repair and condition. It was held by the Court of Appeal that the donee was under an equitable obligation to accept that repairing covenant. The right to have the property repaired under that covenant, which the donee thus acquired, did not exist before and could not therefore be something simply not given. It was a benefit to the donor by contract or otherwise referable to the gift, and so within the equivalent estate duty provision to s 102 FA 1986 (*Nichols*, at p 543). That, as Moses LJ remarked at [26], is a matter of law, and it is not confined to the particular circumstances at play in *Nichols* itself.

71. The contrast between *Nichols* and *Ingram* is in the nature of the covenants given in the lease back out of the freehold interest that was the subject of the gift in each case. In *Ingram* there were no covenants given by the donees, other than a covenant for quiet enjoyment, which Lord Hoffmann, at p 303, described as no more than an incident of the leasehold estate which was created out of the freehold interest. Having held that, as a matter of substance as distinct from conveyancing form, the donees never at any time acquired the land free of the donor's leasehold interest, Lord Hoffmann then, at p 304, drew a crucial distinction between the lease as an estate in land and as a contract. To the extent that, in addition to the leasehold estate which the

donor had reserved, the donor obtained any additional benefits, such as those in *Nichols*, those would be benefits falling within s 102, subject of course to those benefits trenching upon the donated property according to the principles described in *Buzzoni*.

5 72. There can in my judgment be no principled distinction between the contractual covenants given by the donee of a freehold interest in a lease back to a donor and such covenants given by a lessee or sub-lessee to a donor in a lease or sub-lease gifted by that donor. The common feature, as noted by Lord Hoffmann, is the contractual nature of those covenants as distinct from those, such as the covenant for quiet 10 enjoyment, which are an incident of the leasehold estate.

73. In those circumstances, in my view all the criticisms of the observations by Moses LJ in *Buzzoni* on this issue are unfounded. Those observations, whilst strictly *obiter*, remain persuasive and should be followed in this tribunal. Furthermore, for the reasons I have outlined, I respectfully agree with the conclusion reached by Moses 15 LJ, and arrive at the same conclusion on the facts of this case.

The double taxation argument

74. There is one final ground of appeal for me to consider, and that is the argument that under the IHT legislation on Lady Hood's death the value of the sub-lessees' covenants would already fall into the charge to IHT, and that because this would 20 introduce an element of double taxation there is no mischief or other good policy reason why the benefit of such covenants should also be brought into charge under s 102.

75. Mr Taube's argument in this respect relied upon the submission that, ignoring the effect of s 102 FA 1986, the estate of Lady Hood immediately before her death, 25 which was chargeable to IHT, included the value of the Head Lease, and consequently the benefit of the sub-lessees' covenants under the Sub-Lease. Mr Taube then referred to s 162(1) IHTA under which, having regard to the mirror covenants in the Sub-Lease, and the consequent right of reimbursement, in valuing for IHT purposes Lady Hood's proprietary interest as tenant of the Head Lease the valuation would 30 preclude any deduction to take account of her potential liabilities to the Cadogan Estate under the Head Lease.

76. Mr Taube therefore argued that the IHT valuation rules would have two consequences: first, the value for IHT purposes of Lady Hood's Head Lease would have included an element for the value of the sub-lessees' covenants under the Sub-35 Lease; and secondly its value could have exceeded its market value, since it would have fallen to be valued for IHT as if there were no tenant's covenants in the Head Lease. He submitted that, in those circumstances, it would be extraordinary for the IHT legislation also to charge the estate of Lady Hood on the value of the Sub-Lease simply because of her right to the benefit of the sub-lessees' covenants, given that the 40 value of those covenants is already brought into account and charged to IHT.

77. If Mr Taube is correct in these submissions there is nevertheless a short answer. Such an effect can have no impact upon the proper construction of s 102, nor on the application of that section to the facts of this case. Even if there is, as Mr Taube has submitted, a risk of double taxation, that would simply be an illustration of the penal nature of the section, as noted by Lord Hoffmann in *Ingram*, at p 304.

78. But my own view, in any event, is that Mr Taube's analysis is in the circumstances of this case is over-pessimistic, for two reasons. First, absent the application of s 102, I do not consider that there could be any element of double-counting in respect of the value of the sub-lessees' covenants. As Mr Taube's submissions went on to say, the value of the right of reimbursement represented by the sub-lessees' covenants is brought into account, in effect, by s 162(1) IHTA disallowing a deduction for the value of potential liabilities under the tenant's covenants in the Head Lease. Secodly, the effect of the application of s 102 FA 1986 would be that the Sub-Lease would be treated, by s 102(3), as property to which Lady Hood was entitled immediately before her death. The effect of that hypothesis, in my judgment, would be that the Head Lease would be valued without reference to the existence of the Sub-Lease, and any right of reimbursement arising out of the Sub-Lease. Accordingly, in my view, s 162(1) IHTA would not operate to exclude any deduction to take account of potential liabilities of Lady Hood under the Head Lease.

79. For these reasons, I reject the argument of Mr Taube that the application of s 162(1) IHTA, or any other principle of valuation for IHT purposes, can affect the construction of s 102 FA 1986.

Decision

80. For the reasons I have given, I conclude that the creation of the Sub-Lease by the late Lady Hood was a disposal by way of gift of property subject to a reservation within the meaning of s 102 FA 1986, and accordingly that, by s 102(3), that sub-leasehold interest falls to be treated for the purposes of the IHTA as property to which she was beneficially entitled immediately before her death.

81. Accordingly, I dismiss this appeal and confirm the determination.

Application for permission to appeal

82. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

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ROGER BERNER
TRIBUNAL JUDGE

RELEASE DATE: 2 FEBRUARY 2016

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