DISCUSS THE POSITION REGARDING THE TAXATION OF PRE OWNED ASSETS[1], COMMENTING SPECIFICALLY UPON USE BY THE DONOR AND GIFTS WITH RESERVATION OF BENEFIT.

While the Treasury might not be amused by the comparison, "Tom and Jerry" cartoons and the use of the POAT legislation by the government have many similarities. Since the introduction in the Finance Act 1986 of the parallel rules on "gifts with reservation of benefit"[2] and "potentially exempt transfers"[3] the industry of tax avoidance, spearheaded in the City of London and then copycatted throughout the country, has been engaged in a frenetic game of cat and mouse with the Revenue. Schemes have been devised, marketed to a willing public that is morally (rightly or wrongly) opposed to inheritance tax and then dissected and challenged by the Revenue's officers at every turn. It could even be said that the spin off from this is that the Revenue has been less forgiving of innocent blunders by less sophisticated clients, lawyers and accountants; an adversarial system entrenched in taxation practice that pits government against Joe public. Are the wheels coming off our democracy?

The Pre Owned Assets Tax "POAT" (or as sometimes described, the "PRAT") tax is meant to perform two functions. The first is to shore up the cracks in the rules on "GROBS AND PETS", (!) and the second as a general shot across the bows of those who would seek to avoid inheritance tax by schemes designed to circumvent Revenue legislation. The Potentially Exempt Transfer "PET" regime introduced in 1986 was intended to encourage timely giving by allowing lifetime gifts to be made, free of Inheritance tax, every seven years. The "Gift With Reservation of Benefit" GROB regime enforced this by stating that those gifts made had to be genuine, with

[1] Referred to throughout as POAT
[2] GROB
[3] PET

no benefit at all reserved to the donor. Hence, I give you my house, fine, but if I give you my house and carry on living there rent free, the benefit reserved is clear, and there will be no exempt transfer, as the gift, the "transfer", never really occurred. By the time POAT was first announced in December 2003, a myriad of schemes existed that managed to get around the GROB regime, and these schemes were being rolled out in the country, not just for high net worth individuals but in theory, for anyone with a three bedroom house in the South East of England. Such an individual would have sufficient assets in their or their and their partner's names to exceed the then nil rate band allowance of circa 250,000. However, the PET regime would not help, as the value at risk of IHT was largely in the matrimonial home, which could not simply be given away, nor could a market rent be paid without reducing one's standard of living. Fear not however! One's helpful provincial solicitor was at hand, and the use of home loans, double trusts, reversionary leases and cash gifts were all being employed to enable one to have one's cake and eat it, to remain in occupation rent free with no tax payable on death for the privilege. The Revenue were well aware of this, and as Tom would have, they pursued Jerry all the way to court, which, sadly for them culminated in defeat, notably the Ingram and Eversden cases in which the clever schemes were upheld as non-contravening the GROB rules. The Revenue's reaction was to legislate, which brings us to POAT. The trouble is, for various reasons, this tax does not just clamp down on various schemes. Nor does it simply extend the GROB rules. Instead, it introduces another layer of legislation onto one which was already far from simple. Problem one, the laws are now too complex. Furthermore, it is so broadly drafted as to catch innocent and non avoiding individuals in its net. Problem two, it created unfairness.

Subject to limited exceptions, the POAT rules impose an annual income tax charge on individuals who continue to benefit from assets that they have given away, in circumstances

where the GROB rules do not apply to that gift. Accordingly the broad principle is that the gift should be either potentially subject to IHT, or to POAT, but not to both. Transactions entered into at any time since 17 March 1986 can trigger a charge, in respect of land, chattels and intangibles, and the legislation, introduced in Schedule 15 of the Finance Act 2004, provides for slightly different rules according to these three categories. In respect of land, an individual will be liable if he occupies it and satisfies either the "disposal" condition or the "contribution" condition.[4] Put simply, either he previously sold the land and is now living in it again, or he previously gave money to someone who bought the house he is now living in. If either applies, he will have to pay POAT, which will be levied on him as an income tax charge; he is deemed to receive the "income" of rent free living, and this income is taxed. Even a novice to tax law, and particularly a conveyancer, who thinks about this statement for a few moments and considers the myriad of situations that this broad rule covers will throw their hands up in despair. Of course, there are a number of both "excluded transactions" and "exemptions", that soften the blow, but because the legislation starts from the broad premise and then exempts scenarios, rather than simply outlawing specific instances, there is a greater chance of common transactions being caught that were done without IHT planning in mind, or ever any IHT benefit to be obtained. Hence, we now have a situation where an individual whose estate is within the IHT threshold and would never be subject to it could still be made subject to a tax designed to stop IHT avoidance.

Exclusions

As the legislation was drafted so broadly, a broad exclusion protecting such people, who have no intention to avoid, a "mens rea" test for instance, would perhaps have been the buffer required to

[4] Para 3(1)

prevent this unfairness. However, the exemptions and exclusions are narrow and complicated. They overlap, and not neatly, with the GROB rules. Pity the poor practitioner in a mid-tier firm, trying to keep costs down and still provide sound advice! The key to doing so is in a detailed understanding of the ways in which the Revenue has provided for an individual who is prima facie within the POAT net to be let off the hook. These are set out in the legislation as "exclusions" and "exemptions". There are several exclusions, slightly different depending upon whether a disposal or a contribution is in question. They are found in paragraph 10 of Schedule 15 (section 84) and include, inter alia:

1. Disposal of the whole asset at arm's length
2. Transfers between spouses
3. Contributions made at least 7 years prior to occupation

For arm's length disposals, the exclusion is surprisingly inflexible. The disposal must be of the whole asset, disposals of part of an asset even for full consideration do not gain the exclusion. This is a trap for the unwary, and the injustice created was raised by lobbyists with ministers, with the result that on March 7 2005 the Paymaster General issued a statement on the matter and subsequent secondary legislation ensued. This extends the exclusion so that it will apply to some sales of part where either the sale is to (essentially) a commercial entity or a connected person. The extension to include sales to commercial entities enables equity release schemes available in the marketplace to continue to operate. The extension to sales to connected persons is not so straightforward. It stipulates that such sales must be on such terms as would exist between non-connected persons i.e. at market rate, and the disposal was for consideration not in money or in the form of readily convertible assets or the disposal was made before the above-referenced ministerial statement. Consequently, all new part sales to connected persons for cash will not

gain the benefit of the exclusion. There is therefore a very limited range of options within the family in this respect, with the payment for a building extension or loft conversion being cited as possible allowable transactions. Given the tough financial conditions imposed by most equity release companies, and the natural inclination of individuals to retain some legal interest in their home, one sees a large number of POAT liable transactions occurring in the future, unknown to the participators until it is too late. Consider the widow whose children have helped her financially by buying a share of the house for cash. She is in occupation, and she has disposed of the land, she therefore satisfies the occupation and contribution conditions. There seems little logic in penalising her because the disposal was not of the whole, but POAT will apply.

Second, the transfer of property by an individual to his spouse will be an excluded transaction, which has the effect of nullifying the "disposal" for the purposes of the disposal condition. However, while the exclusion will apply on a transfer to a former spouse (upon a court order), there is no let out if the transfer has taken place prior to marriage. This is another trap. If I give my partner cash to purchase a house which we then live in, the contribution condition is breached and POAT becomes payable. Apparently, even if we subsequently marry, there will be no protection from POAT after the date of the marriage![5]

Third, contributions made seven years prior to occupation must be of cash, which could catch out an individual who gifts, say, shares to another which are subsequently sold and used to purchase property which the donor moves into seven years in the future. This is subject to the tracing rules of reserved benefits, which, if applicable, would bring the property back into the donor's

[5] Pre owned assets and tax planning strategies, Chamberlain and Whitehouse, page 62

estate for IHT and thereby outside of the scope of POAT.[6] Either way, the need for advice is increased for what are ostensibly a simple series of transactions.

Exemptions

These are found in paragraph 11, the two most useful being the "ownership" and the "reserved benefit" exemptions. Unlike excluded transactions, these apply to settled intangible property as well as land and chattels. However, it is considered generally preferable to have a transaction excluded under paragraph 10 then exempt under paragraph 11, as will be shown below.

First, if the property in question remains part of the taxpayer's estate for IHT purposes then it is within his "ownership" and thereby exempt. This rule is also extended to other property in the donor's estate which derives its value from the relevant land or chattels. Moreover, the property may not actually be IHT taxable on death, due to the nil rate band or spouse exemption for instance, but because, prima facie, it is part of his aggregable estate, it will be exempt under this heading. A likely scenario where the exemption may apply will be where an individual retains an interest in possession in settled property. Quite often and elderly client will consider transferring the matrimonial home into an interest in possession trust for herself for life, remainder to her children, with the intention of protecting the asset from being applied to pay for her care. As she continues living in the house the disposal and occupation conditions are satisfied, and the disposal is not excluded under paragraph 10. However, for so long as she retains an interest in possession she will be exempt from the POAT charge. However, if the interest in possession ceases while she is alive and continues to occupy the property, then the charge will again apply. Contrasting this with the rules on exclusions, if the original transaction

[6] See exemptions, below

was an excluded one, then it would remain excluded notwithstanding this change in circumstance.

Furthermore, if the donor does not wish to pay POAT but the asset in question is successfully outside of his estate, he can gain the benefit of the exemption by "electing" for IHT to apply to the asset previously owned, via form IHT 500. However, there are time limits to be observed, and not every situation will be appropriate.[7]

Second, if it is subject to the reservation of benefit rules (or is specifically exempt from those rules), then it will be exempt from POAT. As aforementioned, the intention is that either POAT or IHT will apply, but not both. The problem with the exemption is that it is not always clear whether or not the GROB rules will apply as those rules, themselves grafted onto the IHT rules, are not perfectly drawn. It remains unclear, for instance, whether certain of the reversionary lease schemes are caught by the GROB rules. Be that as the case may be, knowledge of GROB is crucial to an understanding of the POAT rules, not just to appreciate when GROB applies and therefore exempts POAT, but to be able to advise clients of the significant let outs from it that are indirectly available. Therefore, the several exemptions to GROB contained within s102 FA 1986 must be studied in detail. They include gifts to charities and political parties, gifts of land co-owned with the donee, gifts of land followed by occupation for full consideration and gifts followed by a change in the donor's circumstances. The one most likely to bring a sigh of relief to the practitioner is contained in s102B(4) FA 1986 which applies to shared occupation of land by donor and donee. It is not unusual for a parent to give a share in their home to a child in his or her forties who remains in occupation with them and shows no intention of either getting

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[7] See below

married or moving out, usually by way of natural recompense for helping them maintain their affairs as they grow older. S102B(4) exists to ensure that such a gift is not caught by the reservation of benefit rules, so long as no consideration is made for the gift for instance by the adult child paying for all of the household's outgoings. The transfer fulfils both the disposal and occupation criteria, but under the exemption available, if the transfer of value is consequently safe from GROB, it will also be safe from POAT. Bear in mind of course that if the child were to move out, the property would then be subject to GROB.

Last but not least, and actually neither exclusion nor exemption, are the £5,000 annual exemption and the rules on "de minimis" occupation. It is hoped that these will operate to "sweep up" many of the liable arrangements, entered into without motive, that equate to no more than £5,000 rental value per annum or where limited use of the land or other is taken up by the donor. For the former, valuations will generally be required. While the allowance is of benefit, assuming a notional value of £100,000 producing £5,000 per annum, there may be many borderline cases, without intent, which cannot avail themselves of either one.

Having considered the main exclusions and exemptions to the rules, it is appropriate to reflect upon how to provide the best advice to one's clients. There will be two generic situations in which advice is required. The first will be reactively, where a client has entered into any of the aforementioned schemes designed to circumvent IHT, and now has to consider whether or not to unravel the work done on his behalf. The second, proactively, prior to any transfers taking place, with careful thought given to the ramifications thereof. For those with, for instance, "Ingram" schemes to unravel, whereby, in essence, they have given away a property and taken back a rent-free lease, the options are limited. They can pay the income tax charge, which will obviously be more practicable for the client of advanced years with limited life expectancy. They can cease to

occupy the property, although the associated operations rules may reduce the viability of this option and the terms of the lease itself may not allow it. For the younger donor, they can elect for the property to fall within the reservation of benefit rules, although this would be disastrous if they subsequently cease to occupy it, as he would then be making a deemed PET under section 102(4), thereby restarting the seven year clock. If the client is at all unsure about his intention to remain in the property therefore, he should not be advised to make an election into GROB. In terms of pro-active planning the first point to bear in mind is that, while IHT schemes are not generally subject to the rules on early disclosure to HMRC, schemes devised to avoid POAT relate to income tax and may therefore require disclosure.[8] Thereafter, greater use should be made of the basic IHT exemptions and reliefs, particularly the transferable nil rate band, lifetime gifts around a seven year cycle, and the hitherto largely forgotten, normal expenditure out of income exemption. These options, together with sharing arrangements protected by s102, commercial equity release schemes and flexible will planning will, by and large, provide straightforward routes that do not fall foul of POAT, whilst achieving sound estate planning for the client. The trouble is, for every client prepared to take the time and expense to procure the advice, there will be another who does not. With the advent of "Tesco law", how many executors will discover, when it is too late, that an income tax charge, totally outside the perception of the layman, has accrued for the last fifteen years and must now be paid, with interest and penalties. The treasury may not see this as a storm in a teacup, but this writer does.

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[8] Depending on whether the other conditions on disclosure are satisfied.