Inheritance tax & 'pre-owned assets'

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Many constituents have been concerned about proposals to change the way a person's main residence is treated for inheritance tax purposes which may have retrospective effect. In the *Pre-Budget Report* in December 2003 the Government announced a series of measures to tackle tax avoidance, including a change in the rules regarding the treatment of "gifts with reservation" for inheritance tax, "where the former owner continues to enjoy the benefits of ownership of an asset. Finance Bill 2004 will legislate to impose a charge on the benefit gained from using the asset, following consultation."[1]

In the 2004 Budget the Government confirmed that this free-standing income tax charge on 'pre-owned assets' would be introduced from April 2005, although the charge "would not affect legitimate transactions between family members."[2] Provisions were introduced in the *Finance Act 2004* (section 84 and schedule 15), leaving certain matters to be dealt with in secondary legislation. Consultation was launched in August 2004, and details of the Government's approach were given in two statements on 7 & 8 March 2005;[3] regulations were laid and approved soon after.[4] Regulations have also been laid to provide relief from double inheritance tax charges in situations where arrangements caught by the pre-owned assets income tax provisions are dismantled.[5] Detailed guidance is published on HM Revenue & Customs site.[6] This note gives some background to the introduction this new tax charge, and the responses there have been to it.

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1 HM Treasury Pre-Budget Report press notice PN 6, *Tackling tax avoidance*, 10 December 2003. The Revenue issued a consultation document at this time: *Tax treatment of pre-owned assets*, December 2003.
2 *Budget 2004* HC 301 March 2004 para 5.88
3 HC Deb 7 March 2005 cc 99-100WS; HC Deb 8 March 2005 cc 103-4WS
4 The *Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations* SI 2005/724. The regulations were approved without debate.
5 The *Inheritance Tax (Double Charges Relief) Regulations* SI 2005/3441
6 http://www.hmrc.gov.uk/poa/index.htm

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A. Inheritance tax – an introduction

Inheritance tax (IHT) is levied on the value of a person's estate at the time of their death. The tax is charged at 40% above the tax-free threshold, which is £285,000 for 2006-07. When calculating the taxable value of a person's estate, transfers made out of someone's estate within seven years of their death are included. There are some gifts which one can make in the last seven years of one's life which do not attract tax (for example, gifts made during the one tax year of a total not exceeding £3,000). Certain gifts are exempt from tax irrespective of their size, and irrespective of whether they are made during one's life, or made under the terms of one's will (for example, gifts made to one's spouse).[7]

Gifts which do not fall under these criteria may be "potentially exempt transfers" (PETs). PETs become exempt from IHT if the donor lives for *at least* seven years after having made the gift concerned (this is known as the seven year rule). If the individual dies during this seven year period, the PET becomes a chargeable transfer, and its recipient becomes liable to pay the tax charged on it. Of course whether IHT is charged on the gift in practice would depend on the value of the donor's estate at death, and whether both gift and estate came to less than the zero-rate threshold (ie, £285,000 for 2006-07).

In certain circumstances one may make a gift and yet retain an interest in it. For example, the donor of a gift may not really lose possession – say, where they give away a valuable painting but insist that it continues to hang in their own house. Alternatively the donor may continue to derive some benefit from the gift; an example would be where a parent gives their house to their child but continues to benefit from it by living in it rent-free. This type of gift is called a 'gift with reservation' (GWR) – and for the purposes of IHT these gifts are treated as forming part of the donor's estate immediately before their death. The legislation defines GWRs as gifts where either:

- the donee does not assume bona fide possession and enjoyment of the property at the date of the gift or 7 years before the donor's death, if later; or
- at any time in the period ending with the donor's death and beginning 7 years before that date or, if later, from the date of gift, the property is not enjoyed to the entire exclusion or virtually to the entire exclusion of the donor.[8]

Where a donor makes a gift and initially reserves a benefit but then relinquishes that reservation, they are normally treated as making a PET at the time they gave up the reserved benefit.

Certain exemptions are made to these rules. Someone who has given away their house but goes on living in it may avoid the gift being classed as a GWR if they pay a market rent or offer rent-in-kind of an equivalent value. In addition the gift of a house is not counted as a GWR if the donor's enjoyment of the property arises out of an unforeseen change in circumstances, and the donee is the spouse or a relation of the donor.[9] One example would be where someone gave up a house to their children, moving somewhere smaller. If, some years later,

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[7] Details are given in the HM Revenue & Customs leaflet, *Inheritance tax on lifetime gifts IHT2*, April 2004, which is available at: http://www.hmrc.gov.uk/leaflets/iht2.pdf. The department was created by the merger of the Inland Revenue and HM Customs & Excise in April 2005.

[8] under section 102 of the *Finance Act 1986*

[9] under para 6 to schedule 20 of the *Finance Act 1986*

they were forced by ill health to move back to this house to be looked after by their children, the 'reservation' element of their original gift would be ignored. Such a gift would only be treated as a PET if the donor's change of circumstances - ill health, financial ruin - were unforeseen at the time the gift was made, and were not brought about by the donor to receive this benefit.

B. Recent changes to the 'gifts with reservation' rules

The rules regarding 'gifts with reservation' were tightened up at the time of the March 1999 Budget[10] following a judgement by the House of Lords on a scheme that had been used to exploit these rules.[11] In this case the late Lady Ingram had avoided the gift of her house being classified as a GWR by setting up a 20 year lease, allowing her to occupy the property rent free, before giving away the freehold. In December 1998 the Lords ruled that the use of this scheme was not captured by the GWR rules – as, in its view, the retained lease, which enabled Lady Ingram to continue to occupy the property rent-free until her death, did not amount to a reservation of benefit in relation to her gift of the freehold interest.[12]

A further change was made in these rules during the progress of the Finance Bill in June 2003, in response to the Court's ruling on a second avoidance scheme.[13] Details were given in a press notice issued at the time:

> Gifts made in a donor's lifetime are in general "potentially exempt transfers" (PETs): that is, they are exempt from IHT so long as the donor survives the gift by at least seven years. Finance Act 1986 (section 102 and Schedule 20) contains special rules on the taxation of lifetime gifts where the donor reserves or receives any material benefit in relation to the gifted asset. These 'gifts with reservation' (GWR) rules are intended to prevent the avoidance of the IHT charge on death through PETs which reduce the value of the donor's death estate, while leaving the donor to continue enjoying the asset concerned much as they did before the gift.
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> For the purposes of the IHT charge on death, a gift subject to a reservation is effectively treated as made at the time when the benefit available to the donor ceases. If the benefit is available at the time of the donor's death, the gifted asset is treated as still being part of the donor's estate on death. Where the benefit ceases during the donor's lifetime, they are treated as having made a PET at that time of an amount equal to the then value of the gifted asset.
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> But there is an exception to these GWR charges where the gift is made in specific circumstances or to specific beneficiaries, including the donor's spouse. Litigation in the case of "Eversden" recently decided against the Inland Revenue in the Court of Appeal. This raised the question how far the exception for gifts to a spouse applied to a case where a gift was made into trust, initially giving an "interest in possession" in

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10 Inland Revenue Budget press notice IR28, 9 March 1999

11 Under section 104 of the *Finance Act 1999*. This provision was scrutinised at the Committee stage of the Finance Bill on 15 June 1999: SC Deb (B) cc 551-558.

12 *Ingram and another v IRC* [1999] STC 37. The judgement was reported in the *Times* on 16 December 1998 ("Law report: donor retained sufficient interest for tax purposes").

13 *IRC v Eversden and another* [2003] EWCA Civ 668. The judgement was reported in the *Times* on 30 May 2003 ("Law report: tax avoidance scheme works").

> favour of the donor's spouse, but where this interest came to an end leaving a continuing reservation in favour of the donor.
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> The Court decided that such a gift is wholly excluded from the GWR rules, while acknowledging that this left significant scope for IHT avoidance through artificial schemes. For example, a trust can be set up by lifetime gifts of property which the donor in fact intends (and needs) to use for the rest of their life; the trust initially gives an interest in possession to the donor's spouse, but on terms that this can be terminated, or will end automatically, after a brief period; and the property is then held on discretionary trusts for a class of beneficiaries including the donor.
>
> The trustees would typically allow the donor the dominant and possibly exclusive benefit from the trust property so long as they are alive and require it: but under the law as the Court of Appeal has found it the property would be entirely removed from the donor's taxable estate. Ministers are aware of significant activity marketing schemes seeking to exploit this weakness and have introduced this new clause to curtail further loss to the Exchequer.[14]

The Paymaster General, Dawn Primarolo, introduced this provision at the report stage of the Bill, and an extract from her speech is reproduced below:

> This new clause introduces the changes announced on 20 June to the inheritance tax rules on lifetime gifts. The changes come in response to a recent Court of Appeal decision in the Eversden case. Everyone who has commented on the case has noted the wide-ranging tax-avoidance opportunities that it opens up. Almost all have gone on to say that they were too good to last and were bound to be tackled by early countervailing legislation. I agree with that assessment, and the Government have introduced this clause to achieve that.
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> I shall set out the relevant factors briefly. The Court of Appeal confirmed that married wealth owners could make what are called gifts with reservations. They are permanently free of the normal tax consequences, so long as the gifts are made to a trust and the trust initially provides an interest in possession to the donor's spouse. That means that married couples could remove assets from their inheritance estates, effectively without limit, by making lifetime gifts into the trust in the way that I have described, without losing any effective ownership. They could do so by using schemes where the interest for the donor's spouse is quite blatantly inserted purely to get the desired tax effect and is predestined to disappear after the shortest decent interval once it has served its purpose. The schemes were of wide appeal, at least among the minority of people wealthy enough to have prospects of paying inheritance tax. The only essential requirement was that the donor should be married and have the prospect of wealth at death of more than £250,000 …
>
> I remind the House that we are talking about the inheritance tax rules that were introduced in 1986, under the previous Conservative Government, and about the ways that people try to get around them. The schemes could be used for all sorts of assets at all levels of wealth. They could allow married couples to remove the family home from inheritance charge on death, yet to continue to live in it during their lifetimes. That aspect has received much attention in the press, and among some of those who market these schemes. However, the schemes could be used equally well

[14] Inland Revenue press notice, *Corporation tax and inheritance tax: blocking tax avoidance*, 20 June 2003

to shelter all sorts of other assets, including—notably—financial assets wrapped up in the form of an insurance bond. As for the amounts involved, the sums become a little more complicated if the couple's total wealth is significantly more than £1 million or so. Although executing one of these schemes at that level would not necessarily remove a couple from inheritance tax forever, it would remain a very attractive proposition.

The Government are not stopping, as some have suggested, an innocent piece of self-help for couples with modest homes who might be taken into inheritance tax by inflation in property prices. Even if that were true, tolerating tax avoidance would not be a sensible way to deal with the issue of house prices. In reality, however, the potential avoidance goes much wider, as I said. It goes all the way up the scale of wealth, undermining all the revenue from those who pay inheritance tax and account for the lion's share of the total yield. That is not fair to the wider body of taxpayers, nor to the balance of prospective inheritance tax payers, who cannot afford this sort of avoidance, or who do not engage in it. Following on from the Court of Appeal ruling, it is essential that we stop now any possible future loss to the Exchequer. That is what the clause seeks to achieve, operational from 20 June.[15]

C. Proposals relating to 'pre-owned assets'

In the *Pre-Budget Report* in December 2003 the Government announced that it intended to introduce a new tax charge on individuals who enjoyed the benefits of gifts they had made that were not captured by the rules for GWRs. A short consultation document was published, one of a series related to the taxation of trusts. Responses were invited by 18 February 2004. An extract is given below:

Legislation will be included in Finance Bill 2004 which will provide for:

- income tax to be charged each year (under Case VI of Schedule D) on the benefit of using an asset formerly owned by the user unless it has since been sold to an unconnected party in a bargain at arm's length;
- extensions to cover cases where one asset is replaced by another, or where the beneficiary originally provided cash to fund the purchase of an asset for their use (rather than providing an asset they already owned);
- rules for valuing the benefit: subject to points made in the consultation, Ministers envisage that this will be at market rent where market evidence allows (e.g. for real property) and at a specified percentage of capital value (e.g. calculated at the "official rate" of interest for benefit-in-kind purposes) in other cases (such as art or antiques);

This will be subject to:

- a set-off for any rent actually paid for the benefit;
- an exclusion for incidental use;
- an exclusion for cases where the donor has expressly reserved a right to continued occupation when making the gift;
- a substantial de minimis exclusion set at a cash amount which Ministers will determine in the light of this consultation;
- any other exclusions or modifications which seem appropriate, given Ministers. objective for the charge, in the light of this consultation;

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[15] HC Deb 1 July 2003 cc 195-6

- a power to make further exclusions by statutory instrument.

> **Operative date** The charge, will apply whenever a benefit is received in chargeable circumstances in or after the income tax year 2005-06. Arrangements which currently exist to provide benefits for former owners will not be chargeable if they have been dismantled, or the former owner starts to pay a full rent, by 6 April 2005.[16]

At this time the *Financial Times* reported that '20,000 households' might be affected:

> The Inland Revenue plans to impose a harsh new tax regime on thousands of homeowners who have set up so-called "home-loan schemes" to avoid inheritance tax on their houses … The Revenue's action is highly unusual in that it applies to existing schemes, even those set up some years ago. Lawyers and accountants that market the schemes estimate that up to 20,000 households will be affected … Home-loan schemes are designed to get around Revenue rules brought in to ensure that "gifts with reservation" - where donors give away assets but maintain the use of them - are subject to inheritance tax. These plans work on the basis that taxpayers sell the house they live in to a trust in return for an IOU. The taxpayer then gives the IOU to heirs through another trust, but continues to live in the house. The Revenue plans … would force donors to pay income tax on the estimated benefit of continuing to live in the house. The Revenue is allowing people until April 2005 to dismantle these plans or start to pay full rent. After then, most people who have set up home-loan schemes will be taxed in this way.[17]

Many argued the proposals were 'retrospective' as individuals would have to dismantle this type of legal arrangement, whenever they had it drawn up, to avoid the new tax charge:

> The pre-Budget proposals state: "Income tax is to be charged each year on the benefit of using assets formerly owned by the user, unless it has since been sold to an unconnected person." According to Richard Kirby, an IHT expert at Speechly Bircham, the solicitor, this could have serious consequences. The Government rather glibly assumes that the retroactive effect can be sidestepped because people who have implemented these strategies can unwind them before April 6 2005, when the new proposals are due to be implemented, he says. But this is not possible in cases where gifts have been made in trust to minor children as the trustees would, arguably, be neglecting their duty if they allowed the gifts to be returned. Even some adult offspring may not be prepared to "play ball" and give back assets.[18]

A second piece in the technical journal *Taxation* also made this criticism:

> The proposals involve retrospective taxation given that they will apply to existing arrangements whenever implemented, or perhaps, given that the purpose is to bolster the leaking reservation rules, if implemented after 17 March 1986.[19] Similar charges were raised in relation to the Finance Act 2003 amendments to offshore

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[16] Inland Revenue, *Tax treatment of pre-owned assets*, December 2003 pp 2-3. It is still available at: http://www.hmrc.gov.uk/consult_new/taxtreat_preowned_assets.pdf

[17] "Inheritance tax trusts blitzed", *Financial Times*, 13 December 2003

[18] "Brown plots a swingeing tax - and it will be retrospective", *Sunday Telegraph*, 18 January 2004. See also, "Tax threat to gifts between husbands and wives", *Times*, 15 February 2004 & "Brown to axe inheritance loopholes", *Sunday Times*, 14 March 2004.

[19] [The author is referring to the introduction of the GWR rules, first announced in the 1986 Budget and which took effect from Budget day, which was 18 March that year.]

trusts, but Treasury Ministers then dealt with the issue by asserting that 'those who play with fire must expect to get burnt'.[20] In this case the defence will be raised that what is being taxed is an existing state of affairs and that there is no reopening of the original scheme. This is, however, a mere sleight of hand and fails to deal with the retrospective argument. Take the case of Mr A and Mr B who both occupy houses owned by their daughters. In Mr A's case, he had given the house to his daughter and so will be caught by the proposed legislation. Mr B, on the other hand, has never made any gifts and so is untaxed. The present situation is the same in both cases and what determines the imposition of taxation is the past transaction.[21]

D. Budget 2004

In the 2004 Budget the Government confirmed that it would proceed with this proposal; in the light of concerns about its potential impact on families, the Budget report confirmed a number of characteristics of the new tax charge:

[The income tax charge on pre-owned assets]

- will not affect parents or grandparents who have helped their children or grandchildren onto the property ladder;
- will not affect transactions between married couples;
- will not apply where the benefit is incidental;
- will not apply if the assets still count as part of the taxpayer's estate for inheritance tax purposes;
- will not apply if a person who has used a contrived avoidance scheme to remove their property from the inheritance tax system opts to bring the property back into their estate for inheritance tax purposes; and
- is not retrospective as it will not take effect until April 2005.[22]

Full details were given in a Budget Notice issued by the Revenue:

General description of the measure
Pre-Budget Report announced that a free-standing income tax charge will apply from the 6 April 2005 to the benefit people get by having free or low-cost enjoyment of assets they formerly owned (or provided the funds to purchase). The charge will apply in appropriate circumstances both to tangible assets (with separate provision for land, including living accommodation, and for chattels) and to intangible assets. Broadly following the model of the benefit-in-kind charge on employees, the rules will quantify an annual cash value for the benefits enjoyed by a taxpayer: this will be treated as an addition to their taxable income, subject to a de minimis threshold, and a set-off for any amounts made good by them for the benefit.

Operative date The charge will apply when a benefit is received in chargeable circumstances in or after the income tax year 2005-06 …

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[20] [The reference is to the provisions in section 163 of the *Finance Act 2003*, which were scrutinised at the Committee stage of the Bill: SC Deb (B) 17 June 2003 cc 573-586. The Paymaster General discussed the issue of retrospection at cc 579-80.]

[21] "Home loan attack", *Taxation*, 8 January 2004. Similar articles appearing at this time included, "Not cricket", *Taxation*, 29 January 2004; "In my opinion", *Tax Journal*, 2 February 2004; "Legalising pot", *Taxation*, 5 February 2004.

[22] *Budget 2004* HC 301 March 2004 para 5.88

Current law and proposed revisions
Following consultation, the Government has confirmed, and proposes to extend, the exclusions outlined in the consultation document published following the Pre-Budget Report. So the proposed charge will not apply to the extent that:

- the property in question ceased to be owned before 18 March 1986;
- property formerly owned by a taxpayer is currently owned by their spouse;
- the asset in question still counts as part of the taxpayer's estate for inheritance tax (IHT) purposes under the existing "gift with reservation" (GWR) rules;
- the property was sold by the taxpayer at an arm's length price, paid in cash: going further than the consultation document, this will not be restricted to sales between unconnected parties;
- the taxpayer was formerly the owner of an asset only by virtue of a will or intestacy which has subsequently been varied by agreement between the beneficiaries; or
- any enjoyment of the property is no more than incidental, including cases where an out-and-out gift to a family member comes to benefit the donor following a change in their circumstances.

More generally, the rules for tangible assets will mean that former owners will not be regarded as enjoying a taxable benefit if they retain an interest which is consistent with their ongoing enjoyment of the property. For example, the proposed charge will not arise where an elderly parent formerly owning the whole of their home passes a 50 per cent interest to a child who lives with them.

Intangible assets formerly owned by the taxpayer (or derived from other property formerly owned by them) will be treated as giving rise to a taxable benefit, only to the extent that the taxpayer may derive benefits from them, and those benefits would diminish the benefits potentially available to others. So for example, no charge would apply if the taxpayer has funded life insurance policies held on trust and the taxpayer's continuing claims are limited to particular retained benefits, such as the return of the life assurance premium, and the balance of the policy value is held on trust solely for others. But a charge would be due if, say, the whole value of such a life policy was held on discretionary trusts for a class of beneficiaries including the settlor (and the circumstances were such that the trust property was not covered by the existing "gift with reservation" rules).

Territorial scope The charge will apply to residents of the UK. For taxpayers who are domiciled in the UK (or deemed to be), the charge will apply to their assets anywhere in the world. For taxpayers who are not domiciled in the UK (or not deemed to be), the charge will apply only to their UK assets. For taxpayers who have become domiciled in the UK (or deemed to be), the charge will not apply to any non-UK assets which they ceased to own before they acquired that domicile.

De minimis The consultation document said that there would be a substantial de minimis threshold below which the cash value of benefits in a given year would be disregarded. The Government has decided to set this threshold at £2,500 per year.

An election for transitional relief
A number of responses in consultation made the point that existing users of tax-driven schemes may find it difficult or impossible to dismantle the resulting structure – so eliminating any income tax charge and re-instating the potential IHT charge they originally sought to avoid – although that is, with hindsight, the outcome that many of them would prefer. In response to that, the Government proposes, additionally, that

taxpayers involved in existing schemes may choose a special transitional treatment if they elect for this by 31 January 2007. If they elect, they will not be subject to the new income tax charge in relation to property covered by the election, but the property in question will be treated as part of their taxable estate for IHT purposes, while they continue to enjoy it, in essentially the same way as under the existing "gift with reservation" rules. As under those rules, property subject to such an election would be potentially eligible, in due course, for the normal IHT reliefs and exemptions available, for example, to business and agricultural property, and to heritage assets.

> **Valuation and further consultation**
> The Government has confirmed the approach outlined in the consultation document and proposes that the cash value of benefits should be determined by reference to market rentals in the case of land, and by reference to imputed percentages of capital value in the case of chattels and intangible assets. They would welcome further representations, in the light of the decisions now announced, on the detailed arrangements that should apply to valuation and on the rates of return for chattels and intangibles, so they reflect available market evidence while minimising avoidable compliance costs. They therefore propose to settle these matters in secondary legislation following a further round of consultation which the Inland Revenue will undertake later this year.[23]

The Government's proposal for transitional relief was generally welcomed;[24] the Institute of Chartered Accountants were supportive of the change, although still opposed to the proposals in principle: "We welcome the proposed relaxations, such as the commitment that there will be no double taxation. However introducing an income tax charge on assets, mainly houses, which may have been given away some years earlier, is wrong in principle. Inventing a new income tax charge is unfair as it is not a tax on income. If the Gift with Reservation rules are not strong enough, they should be strengthened."[25] The *Financial Times* discussed the likely impact of the new rules in some detail:

> From April 6, people who dispose of assets such as houses, paintings or boats while retaining the ability to use them will be charged income tax on the retained benefit if they do not pay rent. There are some exclusions. For example, a parent who has gifted money to a child to help fund the purchase of a property would not be liable for an income tax charge on that gift should the parent move into the property at a later stage in life. Transfers of property between spouses will also be exempt from the new charge, as will gifts where a donor ends up as a beneficiary because of a change in circumstances …
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> However, the new tax will contain an element of retrospection: although it will not come into force until April 2005, it will catch transactions made now or at any time back to March 1986. The Inland Revenue says that individuals who have previously transferred assets to avoid tax will be spared the new tax if they agree before January 31 2007 to treat the assets as if they are still in their estate. "A householder can effectively decide to rip up the tax planning he or she has undertaken to date," says David Kilshaw, tax partner at KPMG. "In effect he or she has achieved nothing and

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23 Inland Revenue Budget Notice REV BN40, 17 March 2004

24 "Home loan-schemes lose IHT advantage", 18 March 2004. Other practitioners continued to strongly criticise the proposals: for example, "Is anyone out there listening?", *Taxation*, 24 June 2004.

25 Institute of Chartered Accountants Budget press notice, 17 March 2004

wasted professional costs. This decision needs to be made by January 31 2007, and I suspect most taxpayers will have no choice but to go back to square one."

> The chancellor's announcement also covers so-called "double trusts", which in effect sell the house to a trust in return for an IOU taking it out of a person's estate for IHT purposes. The schemes, which can cost anything up to £10,000 to set up, were considered worthwhile given that IHT is charged at 40 per cent on anything above £263,000. "For some people it may still be better to pay income tax on the property and avoid a big inheritance tax bill," says Mike Warburton, tax partner at Grant Thornton. No one knows exactly what the income tax charge would be for assets that have been gifted, but are still held by the former owner. However, accountants predict that some assets could cost the owner a few thousand pounds a year. "The charges are expected to follow the Schedule E rules that are based on rental value," says Monteith. "For example, on a property that has been given away, but is still used by the former owners, there will be an initial charge of between £1,000 and £1,500 on the gross value of the property. On top of this, there will be an extra taxable benefit at the rate of about 6 per cent times the value of the property minus £75,000."[26]

In its response to this proposal, the Treasury Committee quoted evidence they had received from Anne Redston (at Ernst & Young) and Edward Troup (at Simmons & Simmons):

> Ms Anne Redston … noted that the proposals put forward in the Pre-Budget Report were wide-ranging and would have caught many innocent transactions. She therefore welcomed the announcement in the Budget that the charge to income tax will not apply in a number of situations and that individuals will be able to elect for the asset in question to form part of their estate for inheritance tax purposes and thus avoid the income tax charge. However, Ms Redston noted that "… taxpayers who undertook transactions 18 years ago will now suffer a tax charge which was not in contemplation when the transaction occurred. The only alternative is for them to undo those transactions, either in reality or for tax purposes, if they do not want to suffer the new income tax cost. It is difficult to see why this is not retrospective taxation."
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> Mr Troup told us that the need to act to prevent abuse of inheritance tax raised wider questions about the structure and future of the tax. He considered that the measures on pre-owned assets "represent an ingenious approach to avoidance schemes already in place, but will inevitably increase compliance burdens and worries for those already concerned about the application of the tax …" With regard to whether the measures are retrospective or not, Mr Troup told us that "I do not think the pre-owned assets measure is strictly retrospective but it does have the effect of penalising people who have already done schemes [which they] do not want to unwind."[27]

John Whiting (from Pricewaterhouse Coopers) gave evidence before the Committee at the same time as Mr Troup, and he remained critical of the new tax charge:

> I just do not like this measure. If there is a gap, a problem with inheritance tax, surely the right route is to mend that gap, to do an inheritance tax measure … I was always told income tax was a tax on income and there is no income here. All right, there is going to be a mechanism for deeming the income but the correct route surely is to go

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[26] "Thousands affected by IHT changes", *Financial Times*, 20 March 2004

[27] *Sixth report: the 2004 Budget*, 6 April 2004 HC 479 2003-04 pp 24-5

> and look at the defect that has caused this seemingly unacceptable avoidance. That said, if we are to go down this route, which it seems we are, at least the Revenue have listened to an awful lot of the representations which we have tried to make and have at least let out some of the fairly innocent people who might be caught by what was originally an extremely widely drawn and ill-advised provision. Frankly, I am of the view that this is lazy legislation, it is trying to go down the wrong route. We should be plugging the gap that has caused the problem, not putting another overlay on top.[28]

Following up Mr Whiting's comments, Mr Troup made an interesting point about the context in which this measure was being introduced:

> I do not necessarily disagree with what John has said but I think that there is a wider perspective on this and without, in a sense, supporting the individual particular measure, I think you have to describe it as ingenious … I think the wider context is that if the Government wants to send a message that it is prepared to be rough and tough with avoidance in order to deter the creation of further schemes and the marketing of further schemes and abuse of taxes, which admittedly I would not defend as being well-designed in the case of inheritance tax, this actually is quite an effective way of doing it. I have no doubt, and in a sense I have some relief, that a great deal of time is not going to be taken up, or as much time is not going to be taken up, in designing tax avoidance schemes in the next 12 or 24 months as in the last 12 or 24 months precisely because of what the Government has done this year.[29]

For its part the Committee welcomed "the changes that have been made so far to the initial proposals designed to ensure that the new charge will not affect legitimate transactions between family members", and went on to say that they expected "the details behind this proposal to be scrutinised during the passage of the Finance Bill through the House."[30]

E. Finance Bill 2004

Provision to impose an income tax charge on the benefits of enjoying "pre-owned assets" from tax year 2005-2006 onwards were included in the *Finance Bill* which was published on 8 April 2004. (They now form section 84 and schedule 15 of the *Finance Act 2004*.) Following the Bill's publication the Revenue published a summary of the responses it had had to the consultation document issued in December 2003; the paper described the general reactions to the proposals as follows:

> A significant minority of the responses from individuals were clearly responding to second-hand reports of the Chancellor's possible intentions, and particularly to reports that a charge might apply to situations like gifts between spouses or to straightforward cash gifts to children. Given that it was Ministers' objective, confirmed in the Budget, to focus this measure on tax-driven structures, we have not given further details here where we believe that the position has been sufficiently clarified by the announcements in Budget 2004 and the *Finance Bill 2004*.

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28 HC 479-II 2003-04 Qs 93-94

29 HC 479-II 2003-04 Qs 94, 96

30 HC 479 2003-04 p 25

More generally, we have not spelt out Ministers' conclusions point-by-point on matters of policy judgement (for example, whether it is fair to treat this matter as a proper subject for an income tax charge) when the answer is implicit in their decision to proceed with the proposals as announced in Budget 2004. Ministers did, of course, value these responses and take full account of them in finalising their proposals.

A number of other responses from individuals stressed that any legislation should not affect the future benefits enjoyed by the respondent under a scheme they had already implemented, but either did not offer further comment or did so in the same terms as a number of other respondents.

Of those respondents who offered a reasoned response on the subject matter of the consultation, a majority – whether of representative bodies, firms or individuals – argued against what they saw as a *retrospective* aspect to the proposals in that it will potentially affect future benefits flowing from structures already implemented. Even so, most of these responses made clear that the structures in question had been adopted for tax-avoidance reasons, and many conceded that it was necessary, or at least proper, for Ministers to counter avoidance using comparable structures in the future.

Some of these responses specifically mentioned structures implemented *before March 1986* when the current structure of inheritance tax (IHT) was introduced – that is to say, the exemption of most lifetime gifts and the consequent special rules for "gifts with reservation". They saw a distinct case for protecting such transactions, given Ministers' recent perceived objective to counter IHT avoidance: they argued that no pre-1986 transaction could be regarded as avoidance-driven, and made the point that such transactions may well have already suffered tax, up-front, under the rules in force at that time.

Many of the responses which were ready to accept the case in principle for anti-avoidance action argued that it should be done, as hitherto, in the form of *specific amendment to the IHT code*, tackling what the respondents saw as the technical weaknesses underlying recent anti-avoidance activity. Putting a similar point in rather different terms, a number argued that the approach actually proposed by Ministers – regarding recent IHT avoidance as evidence of a systemic weakness, and tackling it by action through the income tax code – was in some way unfair or improper, although responses were not always able to articulate very clearly why this was so.[31]

The paper provided some insight into the Government's decision to set the de minimis exclusion – that is, the threshold below which the cash value of benefits in a given year would be disregarded – at £2,500 per year:

The consultation document indicated that Ministers intended a "substantial" de minimis exclusion. Responses endorsed this proposal and suggested a range of figures up to and exceeding the IHT nil-rate-band limit (then £255,000). In considering these responses, Ministers saw a link with the scope of any exemptions and abatements for particular circumstances. They do not regard the de minimis relief as affording a "ration of avoidance", and in that perspective would regard a level comparable to the IHT threshold as markedly too high. They believe that transactions

[31] Inland Revenue, *Consultation on the tax treatment of pre-owned assets: summary of responses*, 27 April 2004 paras 5-9

> of that order of value should be covered by the design of the charge and by express exemptions where they are justified. The de minimis provision is designed to cover the sort of dealing within a family circle which people are already accustomed to make without particular thought about potential tax complications. They propose a level of £2,500 imputed income, which is equivalent to roughly £50,000 of capital value (taking the "official rate" of 5 per cent as a guide to conversion) which they believe will encompass the transactions which are realistically in reach for the great majority of families.[32]

The provisions were subject to a long debate in Standing Committee,[33] and again at the Report stage of the Bill on 7 July 2004.[34] One important amendment was agreed to the provisions in Committee: an increase in the de minimis threshold from £2,500 to £5,000;[35] a subsequent amendment moved by the Opposition to increase it further was successfully opposed at Report stage.[36] On both occasions the Opposition put forward amendments to exempt arrangements made before 9 December 2003 – on the grounds that the scope of the income tax charge was retrospective. Speaking for the Conservatives at the Committee stage Howard Flight said, "we think that the correct approach is to change the rules on IHT reservation of benefits and to prevent future gifts that avoid the rules from being made. That hits straight at the principle of retrospection. The Government have instead introduced a new tax on gifts that could apply to any relevant situation going back to 17 March 1986."[37] The Government successfully opposed any such change. In Standing Committee the Paymaster General, Dawn Primarolo, responded to the concern over retrospection as follows:

> Taxpayers make plans for the use of their income in the knowledge that the tax system may change. Retrospective measures in tax law seek to make a charge on benefits that have already accrued, but the schedule does no such thing. The bringing into charge occurs from the 2005-06 tax year. Therefore, the benefits that accrue in that tax year will fall within the charge. If the legislation were retrospective, it would backdate the charge to 1986 for accrued benefits over that entire period, but we do not seek to do that. I absolutely reject the [Opposition's] proposition that the proposals are retrospective. They start in 2005 and will assess the benefits at that point. If the taxpayer does not wish to pay the income tax charge at that time, they make an election. The inheritance tax rules will be deemed to operate, and the property is theirs and will be dealt with at the point at which the estate comes into charge.[38]

The Minister also discussed how extensive this type of tax avoidance had been:

> Successive Finance Acts have tried to keep inheritance tax avoidance under control by disapplying the normal rules in the case of gifts with reservations, and attempting to block loopholes revealed by attempts by tax planners to work around the rules. This Government made the last effort on those lines as recently as the Report stage of what is now the *Finance Act 2003*. Despite those efforts, schemes to circumvent

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32 *op.cit.* paras 15-16
33 SC Deb (A) 18-20 May 2004 cc 237-317
34 HC Deb 7 July 2004 cc 874-906
35 SC Deb (A) 18 May 2004 cc 292-3. A number of other quite technical Government amendments were also made – though they are not discussed in this note.
36 The Minister set out her response to this at HC Deb 7 July 2004 c 898.
37 SC Deb (A) 18 May 2004 c 243
38 *op.cit.* cc 261-2

> the "gifts with reservations" laws continued to multiply rapidly until December 2003. The schemes were increasingly contrived and were being marketed as packaged solutions that could be offered to people by their financial advisers.
>
> We do not have a complete count of how many of those schemes have been executed. It is in the nature of things that the Inland Revenue gets to hear of such schemes—if ever—only when they become active, after the individual concerned dies and inheritance tax rules come into play. Since the pre-Budget report, however, it has been suggested that there are more than 30,000 clients for particular schemes that have had wide success most recently. Assuming that schemes involve assets of the order of £500,000 on average, which seems to be the consensus among their marketers, some tens of millions of pounds, or more, must be wrapped up in them.[39]

On several occasions Members raised concerns that the rules might affect certain situations, which the Paymaster General was at pains to rebut. In Committee John Burnett argued "people … can fall foul of the legislation and be completely unaware of the fact":

> Say a daughter or son moves in with their parents, entirely altruistically, and cares for them, forsaking an opportunity to get on the property ladder, and spends money improving the property and refurbishing it. Of course, the daughter or son is saving the state thousands of pounds by looking after the parents, but they will probably fall into the charge to income tax, because they will, by operation of law, have an equitable interest in the property … It is well known that young sons or daughters take on businesses and work for 20 years or so, having been told, "This business will one day be yours." Will they face an income tax charge levied over 20 years?[40]

The Minister responded to these points as follows:

> The hon. Member for Torridge and West Devon suggested that a daughter who moves in with her parents in order to care for them has an interest in that house, and that she will be caught by the schedule and the clause. That is wrong. If she has a share in the house, that is part of her estate and there will be no charge under the clause or the schedule … the hon. Gentleman [also] … gave the example of a father and son working together on a farm. Again, that example was incorrect. The principles mean that if, for example, a son has worked for little or no reward on his father's farm, they should have regard to a part share of the farm. That is exactly how the rules operate. Each will have a share that is part of his estate, so no charge will arise under the clause or the schedule. The father has received full consideration, in the form of labour, for what he has given up. That example is another red herring, and would not be caught by the clause or the schedule.[41]

Following the *Finance Act 2004* receiving Royal Assent, the new rules were discussed at some length in the technical press.[42]

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[39] *op.cit.* cc 237-8

[40] SC Deb (A) 18 May 2004 cc 241-2

[41] *op.cit.* c 255. There was a similar exchange between Mr Burnett and the Minister at the Report stage (HC Deb 7 July 2004 cc 884-5).

[42] for example, "The pre-owned assets régime I & II", *Taxation*, 16 & 30 September 2004; "What to do?", *Taxation*, 7 October 2004; "Loans and gifts", *Taxation*, 25 November 2004.

F. Introduction of the new charge – April 2005

In the 2004 Budget the Government explained that there would be a second round of consultation on certain aspects of the pre-owned assets (POA) charge; specifically, the detailed arrangements to apply to the valuation of pre-owned assets, whether of land, chattels or intangible assets.[43] A consultation document was issued in August, with responses invited by 18 November 2004;[44] this detailed the areas to be covered by regulations:

> The rules for establishing the benefit which is chargeable are set out in Schedule 15, *Finance Act 2004*. The precise machinery - and therefore the matters to be covered in the forthcoming regulations - depends on the nature of the assets in question.
>
> In the case of land, the "cash equivalent" of enjoyment in a particular tax year is derived from *market rental* that would be paid for use of the land over the "taxable period" (that is, the tax year or any shorter period for which the asset is "caught" by Schedule 15). This figure is then scaled down, in cases where the taxpayer's "stake" in the caught asset is less than 100 per cent, in the proportion DV/V, where V is the value of the whole asset on the "valuation date" for the year, and DV is the value reasonably attributable to the taxpayer on that date. In many cases, however, we would expect that taxpayers and their advisors will be able to establish the ratio DV/V from the surrounding circumstances without necessarily establishing the absolute amount of V or DV.
>
> In the case of *chattels*, the "cash equivalent" of enjoyment in a particular tax year is found by applying a specified rate-of-return, over the "taxable period", to the capital value of the asset as at the "valuation date" for the year. As with land, the cash equivalent may then fall to be scaled down in the proportion DV/V, though again we would generally expect this ratio to be found without the absolute values of DV and V needing to be estimated.
>
> In the case of *intangible assets*, the cash equivalent is calculated, as for chattels, by applying a specified rate-of-return, over the "taxable period", to the capital value of the assets as at the "valuation date". There is, however, no provision for scaling down this figure, equivalent to that made for land and for chattels.
>
> It follows therefore that the following regulations must cover two matters in order for the charge in Schedule 15 to be fully operational at the beginning of tax year 2005-06:
>
> - a valuation date must be specified for all assets in each tax year from 2005-06 onwards;
> - a rate-of-return must be specified for chattels and for intangible assets from 6 April 2005 onwards.
>
> In both of these respects, the primary legislation is compatible *either* with a uniform rule for all assets in question, *or* with regulations specifying distinct dates.[45]

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43 Inland Revenue Budget Notice REV BN40, 17 March 2004

44 Inland Revenue, *Taxation of pre-owned assets: further consultation*, 16 August 2004 p 3. This is still available at: http://www.hmrc.gov.uk/consult_new/tax-preowassets.pdf

45 *op.cit.* pp 6-7. At the time the Government anticipated that the regulations would be made early in 2005, along with guidance on the operation of the new rules (p 4).

In their summary of responses to this consultation, HMRC commented that the general consensus was "that the machinery should be kept as simple and straightforward as possible, largely to keep taxpayers' compliance costs down … [though] there were also concerns that the system should be fair to taxpayers."[46]

Concerns were raised over the treatment of so-called 'equity release reversion schemes', a legal instrument that elderly householders have used to sell off part of their home while continuing to live in it.[47] An explanation of these schemes is given in an Age Concern leaflet:

> A home reversion scheme involves selling your home or a part of your home to a private company called a reversion company. In return you receive a cash lump sum or a monthly income. You can remain in the house rent-free or for a nominal monthly rent, for the rest of your life. When the property is sold, usually after your death, the reversion company receives the proceeds from the sale, depending on what share of your home you sold. For example, if you sold a 50% share of your home, the reversion company will receive 50% of the proceeds when it is sold …
>
> When you sell your home or part of your home to a reversion company you will not receive the full value that you would get if you sold on the open market. This is because the reversion company gives you the right to live in your home for the rest of your life. So you will only receive a percentage of the market value. The percentage of the value you receive will depend on your age and sex. Older people will get more than younger people and men will get more than women of the same age. This is because they have a lower life expectancy. In some cases the cash sum from the sale can be 35% or less of the house value. It will rarely be more than 60%, even for people over 80. Certain schemes may buy your home at a higher purchase price and in return you would pay an ongoing rent while you live in your home.[48]

In October 2004 several practitioners argued that these schemes would only avoid the new charge for POAs if the Government amended the legislation to specifically exempt them.[49] The issue was raised in a small number of PQs; in answer to one of these the Paymaster General, Dawn Primarolo, stated, "we will ensure that the pre-owned assets measures have no impact on the full range of bona fide equity-release schemes with arms-length providers, while continuing to bear down on schemes aimed merely at avoidance."[50] However, the outcome of this second consultation was not published until March 2005; in a long written Ministerial statement on 7 March the Paymaster General gave details of the valuation date, the 'prescribed rate' and the approach to be taken to valuing assets over long periods, as well as the treatment of equity release schemes. It is reproduced in full below:

Pre-Owned Asset Regulations

> **The Paymaster General (Dawn Primarolo):** Schedule 15 Finance Act 2004 provides for an income tax charge on the benefit that taxpayers gain, in certain circumstances, from the continuing enjoyment of assets they formerly owned. The

46 Inland Revenue, *Further consultation on the tax treatment of pre-owned assets: summary of responses*, March 2005 para 5
47 for example, "Elderly face a 'stealth tax' on equity release schemes", *Daily Mail*, 25 October 2004
48 Age Concern, *Raising income or capital from your home: factsheet 12*, June 2004 p 8
49 "Homes schemes are caught up in tax net", *Financial Times*, 23 October 2004
50 HC Deb 10 November c 699W

primary legislation leaves some matters—the operative date for valuations, and the rates of return which apply for purposes of the schedule—to be specified in secondary legislation. They also allow regulations to provide for assets to be valued less frequently than annually. More generally, they enable regulations to make further exemptions from the charge set out in schedule 15. The Inland Revenue issued a consultative document on 18 August 2004, "Taxation of Pre-Owned Assets: Further Consultation", seeking views on the matters to be covered by regulations. There was a full and constructive response and I am grateful to all who took part. We propose to make regulations as follows, having regard to the responses received.

Valuation date As proposed in our consultation document, the valuation date for a tax year will be 6 April in the year or, if later, the beginning of the taxable period for which the asset in question first becomes chargeable.

The prescribed rate The prescribed rate (to be applied to the values of chattels and intangible assets when quantifying the cash value of the benefit enjoyed) will be equal to the official rate of interest, as defined in section 181 of the Income Tax (Earnings and Pensions) Act 2003. The rate is currently 5 per cent.

Valuations at extended intervals Regulations will provide, broadly, that land and chattels will be valued every five years. That is to say, a valuation will be made as prescribed in the primary legislation for the first tax year in which a particular asset becomes chargeable under schedule 15. That valuation will also be used in any of the four succeeding years in which a charge arises.

If a charge arises in the fifth year after the first chargeable year, a fresh valuation will be made which will apply in the next four succeeding years, and so on for years 10, 15 and subsequent five-year anniversaries. If no charge arises for the fifth year, or any later five-year anniversary, no valuation need be made until the next tax year (if any) for which a charge arises, and a fresh series of five-yearly valuations will start from that year. Valuations will be carried forward in cash terms without adjustment (e.g. for indexation against asset price inflation, as the enabling power would permit).

Equity release Schedule 15 provides exemption for any case where the former owner continues to enjoy an asset they have sold, so long as they have disposed of their whole interest in it (apart from the right of continuing enjoyment) and have done so either at arm's length or on arm's length terms.

It became clear in consultation that this was not sufficient to accommodate all open-market equity release transactions, under which homeowners often sell only a part share in their property. I made clear last autumn that regulations under schedule 15 would cover the full range of bona fide equity-release schemes with arm's length providers, while continuing to bear down on schemes aimed at avoidance. With that in mind, we do not in general think it is appropriate to provide exemption for sales of a part interest which are made otherwise than at arm's length. If one member of a family needs to raise cash, and another member of the family is willing and able to provide it, there are other and more straightforward ways of structuring this than adopting the form of an equity release transaction.

The point was however made in consultation that some intra-family part disposals can arise from patterns of behaviour adopted for good family or business reasons, for example where a child moves in to care for an aged parent and acquires an equitable interest in their shared home as a corollary of that, or where younger members of a family take over the active role in a family partnership, and in doing so acquire an interest from the partners who preceded them. And we also accept that any cases

where asset owners have already sold a part interest within their family are unlikely, given the law as it stood at the time, to have chosen that approach primarily for tax avoidance purposes.

Bringing together these different considerations, the regulations will extend the existing exemption (described above) to all sales done at arm's length where they involve the whole or a part of the vendor's interest in their asset. They will extend this exemption to any part sale, even if not at arm's length, so long as it was made before today and on arm's length terms. And this will also apply to future disposals if they are made for a consideration other than money or readily realisable assets.

Regulations to this effect will be made shortly, in time to take effect from the commencement of the new charge on 6 April. The Inland Revenue will also be publishing their guidance on the interpretation and operation of schedule 15: it will be announced and made available on www.inlandrevenue.gov.uk/.[51]

Practitioners generally welcomed the announcement:

Jon King, chairman of Safe Home Income Plans, the equity release industry's trade body, said: "This is great news, confirming what we wanted." Emma Chamberlain, a specialist barrister who has been involved in talks with the Revenue on the pre-owned assets legislation, said: "The Revenue were clearly worried about not doing anything and have finally recognised that this was pretty unfair and have exempted it as much as they can. This is the best we can hope for." John Whiting, tax partner at PWC, the professional services firm, said: "This was clearly not how the rules were intended to be and this is formal confirmation." In her statement, Ms Primarolo said future part disposals between relatives or partners would be liable for the new income tax charges unless the sale was "made for a consideration other than money or readily realisable assets". Ms Chamberlain said this curious wording might mean the Revenue would be prepared to exempt cases where an adult child moved in with a parent and took on their care in exchange for part-ownership of the house.[52]

The regulations were laid on 16 March 2005, and came into force on 6 April 2005.[53] The regulations also made provision to prevent any double taxation where taxpayers elected to disapply the POA charge; the Minister gave details in a second statement on 8 March:

Pre-Owned Asset Regulations (Double Charges' Relief)

The Paymaster General (Dawn Primarolo): This statement announces regulations under section 104 Finance Act 1986 to provide relief from double inheritance tax (IHT) charges in situations caught by the pre-owned assets provisions at Schedule 15 Finance Act 2004, and is in addition to extended relief from income tax under Schedule 15 which I announced in a written statement on 7 March.

The pre-owned assets legislation in Schedule 15 provides for taxpayers to make an election so that they do not have to pay income tax in respect of a pre-owned asset but instead have the asset treated as part of their estate for IHT purposes. If the

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[51] HC Deb 7 March 2005 cc 99-100WS

[52] "Elderly to be spared home sale penalty tax", *Financial Times*, 8 March 2005

[53] The *Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations* SI 2005/724. The regulations were approved without debate.

taxpayer dies within the next few years after making the election there is a possibility of two IHT charges on the same underlying asset value.

In particular, many taxpayers have used a "double trust" structure: one trust is created to buy the settlor's asset in exchange for an IOU, and this IOU is gifted into a second trust to take it out of the settlor's taxable estate. If the settlor dies within seven years, the estate will be liable to IHT on the IOU; and if they have made an election under Schedule 15 Finance Act 2004, their estate will be also liable on the underlying asset. It is clear from responses in consultation that this prospect is preventing some people from making an election which they would otherwise find attractive.

The regulations will eliminate this double IHT charge so that people who wish to make an election under Schedule 15 can be assured that only one IHT charge will be due whatever the timing of their death.

The regulations will be announced and made available on the Inland Revenue's website at: www.inlandrevenue.gov.uk.[54]

G. Recent developments

At the Report stage of the Finance Bill on 6 July 2005, the POA provisions were discussed at some length.[55] On this occasion Philip Hammond put down a new clause, to rewrite the underlying primary legislation – in the *Finance Act 1986* – with an aim to prevent any chance of double taxation for taxpayers who had decided to unwind a double trust scheme, rather than make an election. The Paymaster General opposed the move, on the grounds that "the regulating powers" granted under the POA provisions "enable the House to respond to detailed cases … there are some valid cases [where double or unfair taxation may arise] … which my officials are taking forward."[56] Ms Primarolo took the opportunity to rehearse the Government's reasons for tackling IHT avoidance in this way:

> [This new clause] … refers to a specific action that the Government took to close double trust avoidance arrangements. Those arrangements are very complicated, and people do not fall into them in error. Double trusts are expensive to set up, and they benefit people who want to remove £500,000 or more from inheritance tax liability, under rules that have been in place for a very long time. The arrangements apply to houses, but also to works of art, furniture and an amazing range of items. In this rather simplified presentation, however, I shall use houses as my example.
>
> Under the double trust arrangement, people would give their house to a trust. The trust then owns the house but the deal is a paper transaction only and so no money changes hands. The trust pays with what is, in effect, an IOU, but that IOU cannot be kept by the house's original owners. Therefore, it is put into another, unconnected, trust. The original owner has neither the property nor the income from it, but is able to continue living in it, even though it has been removed entirely from the inheritance tax regime.

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[54] HC Deb 8 March 2005 cc 103-4WS
[55] HC Deb 6 July 2005 cc 342-360
[56] HC Deb 6 July 2005 c 354

> The Government took various steps to change the arrangements. The classic way to deal with an anti-avoidance arrangement—to which some Opposition Members object—is to introduce complex legislation targeted specifically on removing the possibility of avoidance. This time, however, the Government decided to take a different route and say that people could elect out of existing arrangements … As a result, people could claim, "Fair cop. We shouldn't have tax planned. We didn't mean to do it or for it to carry on into the future. We understand the point that the Government is making." If they did that, people only had to tell the Government that the double trust scheme had been cancelled. By electing out in that way, people could get back to where they should be in the inheritance tax system. That is all that we are discussing.[57]

The Minister went on to argue that as a consequence, the Government would not guarantee that taxpayers would be allowed to unwind schemes facing without a double tax charge in all circumstances:

> When we consulted on the proposals, they were not greeted favourably by the tax planning industry, but that is no surprise … My officials asked the industry whether we needed to consider transitional arrangements while schemes were unwound … At that point, the industry claimed that unwinding was impossible, because the schemes were so complicated.
>
> Therefore, we came up with the simple proposition that the taxpayer could elect out of the scheme by a simple declaration to the tax officials that the scheme would no longer operate. The schemes did not have to be unwound and taxpayers did not have to pay for them to be unwound or pay to take advice on their unwinding. The taxpayers could sign a piece of paper, send it to HMRC and it was done. I thought that that was a good, simple way to solve the problem. However, this year, people are coming back to us and saying, "Hmm, we think we'd like to unwind. Can you give us general powers to unwind schemes?" My answer is no, for the following reasons.
>
> Call me a cynic, but I have a horrible feeling that the sudden desire to unwind is prompted by the discovery of a way to replan. I also think that election is a good and fair answer for all taxpayers ... The power to make regulations remains available so that HMRC can consider using it further, if advisers who favour the unwinding route can make a detailed case that it is designed specifically to reach one end—fairness to the taxpayer—and not to open up other possibilities. That can be achieved through decent dialogue between HMRC and advisers who are concerned about the issue. That is where we are.[58]

Following this, on 21 July 2005 the Minister announced regulations to provide relief where arrangements were dismantled, in certain circumstances:

> **Pre-Owned Asset Regulations (Double Charges)**
>
> **The Paymaster General (Dawn Primarolo):** This is to announce regulations under section 104 Finance Act 1986 to provide relief from double inheritance tax charges in situations caught by the pre-owned assets provisions at Schedule 15, Finance Act 2004.

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[57] HC Deb 6 July 2005 cc 352-3

[58] HC Deb 6 July 2005 cc 353-4

> Double inheritance tax (IHT) charges can arise in certain circumstances when taxpayers who have used IHT avoidance schemes re-arrange their affairs in response to the income tax charge on "pre-owned assets" introduced by Schedule 15, Finance Act 2004.
>
> My statement of 8 March 2005 announced regulations to provide relief from double charges where taxpayers have made an election to disapply the pre-owned asset income tax charge under paragraph 21, Schedule 15.
>
> Comparable double charges can arise where taxpayers do not make this election, but instead dismantle their previous arrangements so that the pre-owned asset income tax charge is no longer due. In particular, many taxpayers have used a "double trust" scheme; this involves selling a valuable asset to one trust in which the vendor retains an interest, in exchange for an IOU, and then giving the IOU to a second trust. The gift is a potentially exempt transfer for IHT purposes, and the value of the IOU will be chargeable if the scheme user dies within seven years of implementing the scheme. If in the meantime the scheme has been reversed, so that the full value of the asset originally sold is back in the scheme user's ownership at the time of their death, that value will also be subject to IHT.
>
> I am satisfied that scheme users can have legitimate non-avoidance reasons for arranging their affairs in this way, and the regulations already made will therefore be extended to provide relief from double charges which arise from their doing so. They will cover cases where:
>
> - a deceased person has made a gift of a debt owed to them;
> - the gift was chargeable to IHT or becomes so chargeable (by virtue of the donor's death);
> - the donor dies within seven years of the gift and on or after 6 April 2005;
> - the debt was entered into as consideration for the purchase of an asset owned by the donor, or to provide funds for such a purchase;
> - the full value of that asset, or of property derived from it, is also chargeable to IHT as part of the donor's estate at death.
>
> In those circumstances, relief will be given so that tax will be due only on the more valuable of the two chargeable assets mentioned.
>
> The regulations will be made as soon as practicable and made available in HM Revenue and Customs' website (www.hmrc.gov.uk).[59]

The regulations were laid on 14 December 2005 and came into force on 4 January 2006.[60] Detailed guidance on the POA provisions is on HM Revenue & Customs' internet site.[61] The new rules have continued to generate considerable interest in the technical press.[62]

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59 HC Deb 21 July 2005 c 111WS

60 The *Inheritance Tax (Double Charges Relief) Regulations* SI 2005/3441. The House approved this Order without debate.

61 http://www.hmrc.gov.uk/poa/index.htm. An introduction to the rules is given in, Jonquil Lowe, *The Which? guide to giving and inheriting 8th edition*, September 2005 pp 83-90.

62 for example, "Charity begins at home", *Taxation*, 28 July 2005; "Walking the POAT", *Taxation*, 8 December 2005; "POA and the common man", *Taxation*, 19 January 2006

In the *Pre-Budget Report* in December 2005 the Government announced a series of measures to tackle tax avoidance including action to "close a loophole which allows individuals to avoid paying either inheritance tax or the income tax charge on pre-owned assets."[63] Further details were given in a notice from HMRC; an extract is reproduced below:

> Schedule 15, Finance Act 2004 introduced an income tax charge from 6 April 2005 on the benefit people get by having free or low-cost enjoyment of assets they formerly owned or provided the funds to purchase. The POA income tax charge does not apply where the asset in question still counts as part of the taxpayer's estate for inheritance tax (IHT) purposes. This interacts with an existing IHT exemption for property held on trust which reverts to the settlor when a beneficiary's interest terminates (or, in some circumstances, where it reverts to the spouse or civil partner or the widow, widower or surviving civil partner of the settlor). Such property is treated as part of the trust beneficiary's estate, but it is not charged to IHT when the beneficiary's interest comes to an end.
>
> The Government is aware of schemes that are exploiting these exemptions to side-step both the income tax and IHT charges using a transfer followed by resettlement of the asset in question for the benefit of the original owner on "reverter-to-settlor" trusts.
>
> The POA income tax charge will in future apply to such situations notwithstanding that the property in question is treated as part of the former owner's estate. This will apply where the former owner of an asset (or a person who contributed to its acquisition) enjoys the asset under the terms of a trust, and the trust property may in due course revert to the settlor – or to the spouse or civil partner or the widow, widower or surviving civil partner of the settlor – in circumstances that are eligible for exemption under sections 53(3), 53(4), 54(1) or 54(2) Inheritance Tax Act 1984. The charge will apply on and after 5 December 2005 or, if later, from the time at which chargeable circumstances first arise. It will apply to all trusts, whenever created, where the trust property will or could revert as just described.[64]

Provision to this effect is made in clause 80 of the *Finance (no.2) Bill 2006*.[65] There does not appear to have been much comment or debate about this measure, although commentaries on the Bill from the Institute of Chartered Accountants, and the Chartered Institute of Taxation, both mention it; for convenience, extracts from each are reproduced below:

> Clause 80 - Restriction of exemption from charge to income tax
>
> 124. The restriction to the exemption from the income tax charge where property is comprised in a person's estate is not properly targeted and catches many situations that should not be caught. The mischief at which the clause is aimed is where property is part of an individual's estate as a result of section 49 IHTA 1984 but will revert to a settlor when that interest comes to an end on death. The clause therefore needs to be more specifically aimed at that since at present it appears to deny the benefit of the relief where an individual has the relevant property in his estate even where the revertor to settlor exemption is not available.

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[63] Cm 6701 December 2005 para 5.116

[64] HMRC, *Pre Budget Report 2005: statements and notices - Pre-Owned Assets (POA) and reverter-to-settlor trusts*, 5 December 2005

[65] There does not appear to have been a separate Budget notice on this measure at the time of Budget 2006.

125. It should apply only to interests created on or after 5 December 2005 and not to other interests.

126. Paragraph 11 of schedule 15 to FA 2004 needs to be amended to reflect the IHT changes in Schedule 20 of this Bill. The principle to be applied is that Schedule 15 FA 2004 imposes an income tax charge in cases of what is seen as IHT avoidance. Where certain interests in possession have now become relevant property, and so are within the IHT regime, there can by definition be no IHT avoidance. It is therefore necessary to ensure that there is no income tax charge under Schedule 15.[66]

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18. Clause 80: Pre-owned assets
18.1 Clause 80 is at variance with the statement in the Press Release issued at the time of the Pre-Budget Report. This indicated that where "reverter to settlor" trusts were set up, the life tenant (A) would cease to have protection from pre-owned assets income tax. In fact clause 80 goes further that this. If A gives away relevant property so it ceases to become comprised in his estate and at any subsequent time it becomes comprised in his estate again as a result of him taking an interest in possession, the relevant property is not treated as comprised in his estate for POAT purposes.

18.2 Whilst this exemption is unlikely to affect future disposals (which will by definition not be comprised in his estate following the IHT changes) it is quite possible that there will be situations where the life tenant (A) originally gave away the property and has now been given it back on trust by B who is therefore the settlor of that trust but B himself retains no interest in it.

18.3 Therefore the reverter to settlor exemption will not be available on the death of A for inheritance tax purposes and so there will be an inheritance tax charge on death and continuing POAT charges on A during his lifetime.

18.4 We think that clause 80 should be amended so that it accords with the stated intention of the Pre-Budget Report. This would be easy enough to achieve by simply saying that the relevant property would not be treated for the purposes of paras 11(1) and (2) as comprised in the life tenant's estate if the settlement is settlor interested or becomes settlor interested (assuming B is the settlor).

18.5 The ability to make an election will not always solve the POAT problem if, for example, A is married because there will be no spouse exemption on A's death which there might be if the property in the trust then passed to A's spouse.

18.6 We urge the Government to seize the opportunity to remove from POAT ordinary families whose estates are below the IHT threshold, but whose domestic arrangement involving property or loans, and entered into without any avoidance motives, have inadvertently brought them within its scope. The anxiety and compliance difficulties facing such taxpayers, who are likely to be elderly and unrepresented, would be overcome by the simple expedient of exempting from POAT persons whose estates are below the IHT threshold.[67]

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[66] Tax Faculty of the ICAEW, *TAXREP 13/06: Finance (no.2) Bill 2006*, 15 May 2006 pp 27-28
[67] CIOT, *Finance Bill 2006: CIOT representations*, 11 May 2006 p 22