AN INTRODUCTION TO THE NEW PRE OWNED ASSETS LEGISLATION

Matthew Wentworth[1]

Introduction

1. Schedule 15 Finance Act 2004 is the most ambitious attempt by the current government to prevent inheritance tax planning to date. In her opening remarks to Standing Committee A the Paymaster General, Dawn Primarolo, introduced the new provisions by saying that they were concerned with "the range of schemes that allow wealthy taxpayers to give their assets away, or achieve the appearance of doing so, and so benefit from the inheritance tax exemption for lifetime gifts, while in reality retaining continuing enjoyment of and access to those assets, much as before"[2]. This article will outline how the provisions work, and see to what extent they have achieved their purpose of blocking these schemes, as well as highlighting the key issues that arise from the legislation.

2. S.102 Finance Act 1986 introduced the widely known gift with a reservation of benefit ("GROB") legislation, which provided that if a donor gave away his property and yet retained a benefit in it, its value would remain in his estate for as long as he retained that benefit. Over the years various devices were contrived to get around these rules, and it is these "abusive" tax avoidance schemes that the new provisions are principally aimed at[3]. However, it is important to note that whilst most of the schemes relate to land, and principally the family home, the new provisions deal with land, chattels and intangible assets.

3. Schedule 15 tackles the schemes by imposing an income tax charge on those who are benefiting from the assets which they have putatively given

---

1 Pupil, Pump Court Tax Chambers, 16 Bedford Row, London, WC1R 4EF

2 D. Primarolo, *Hansard*, Standing Committee A 18th May 2004 Column Number 237

3 Ibid Column Number 238

away. This may appear to be a somewhat peculiar way through which the solution to an inheritance tax problem should be found, but the rationale behind it is that every time the inheritance tax rules are changed to combat this form of avoidance, loopholes can be found which are then exploited[4]. Rather than engage in a root and branch restructuring of the inheritance tax rules, it may be thought to be simpler to impose an income tax charge to ward of these forms of tax avoidance. I will now outline how the income tax charge is imposed in each of the three categories[5].

Land

4. Paragraph 3[6] imposes a charge to income tax where an individual occupies land and either the disposal or contribution conditions are met. The disposal condition is that the individual in question has at any time after 17th March 1986 owned an interest in the land he occupies, or in other property which has been sold and the proceeds applied by someone else to purchase an interest in the land he now occupies, and the individual has disposed of all or part of his interest in the land or the other property, otherwise than by an “excluded transaction”. The contribution condition is where the individual in question has contributed, otherwise than by an “excluded transaction”, part of the consideration for the purchase by someone else of either an interest in the land which he now occupies, or other property which has been sold and the proceeds put towards the purchase of an interest in the land which he now occupies. If these conditions are met then there is a charge to income tax on the “chargeable amount” (paragraph 3(4)). The calculation of the chargeable amount is based on the rental value of the property taking into account the value of the interest the taxpayer had in the land before he disposed of it or the amount of consideration they contributed to the purchase of the land[7]. It also takes into account any amount they received if they sold their whole interest in the land[8].

---

4 Ibid

5 For a very useful flow diagram of how the provisions work see C.Hutton, *Taxation*, 2 September 2004 pp 576-577.

6 All paragraph references in this article are to Schedule 15 unless otherwise specified.

7 Paragraph 4

8 Paragraph 4(4)

5. Two immediate concerns arise from the way the provisions are drafted. The first is that the provisions apply to any arrangements entered into after 17th March 1986. This raises the issue of retrospectivity, which I will discuss below. The second is that the consideration condition applies if an individual contributes <u>any</u> consideration to the purchase of the land, and so even if you contribute a miniscule amount you will be caught. There are two answers to this. The first is that if the consideration you contribute is very low then the rental value under paragraph 4 is likely to be very low. If your rental value (along with any amounts under the chattels and intangible assets provisions) is less than £5000 then paragraph 13 exempts you from the charge. Secondly, and perhaps more academically (though it may apply in certain circumstances) the general principle *de minimis non curat lex* (that the law is not concerned with trifling matters) should apply in interpreting what is meant by <u>any</u> consideration, and so small contributions when compared with the purchase price of the property should not fall within the scope of the provisions. A similar approach should be taken when considering whether an individual has an "interest" in the land for the purposes of the disposal condition.

Chattels

6. Paragraphs 6 and 7, concerning chattels, are similar to those that relate to land. If an individual "is in possession of, or has the use of" a chattel, whether alone or together with other persons, and he satisfies the disposal or contribution condition then he is, on the face of it caught[9]. The disposal and contribution conditions are essentially the same as for land. Importantly the conditions are again not met if the transaction is an "excluded transaction". If the provisions are met then there is a charge to income tax on the "chargeable amount" (paragraph 6(5)). This is calculated by reference to the amount of interest that would be payable if interest were payable at the prescribed rate on an amount equal to the value of the property, with the calculation also taking into account the value of the interest disposed of or the amount of the consideration contributed, as well as any money paid for the disposal of the chattel as long as it is the disposal of the whole of the taxpayer's interest[10].

---

9 Paragraph 6(1)-(3)

10 Paragraph 7

Intangible Assets

7. The charge under Paragraph 8 is different in nature to the previous two charges. The paragraph applies to income arising from a settlement. "Settlement" has the same meaning as in the Inheritance Tax Act 1984 ("IHTA 1984")[11]. The first condition for the paragraph to apply is that any income arising under that settlement will be treated by s.660A[12] as income of the taxpayer[13]. The second condition is that the taxpayer must be a settlor of the settlement for the purposes of Part 15 ICTA 1988. The final condition is that the settlement property must include intangible property which either is, or represents, property which the taxpayer settled or added to the settlement after 17th March 1986. If these conditions are met then the taxpayer is charged to income tax on an amount calculated by reference to the interest that would be payable on the intangible property at the prescribed rate, minus any income tax or capital gains tax charges already attributable to that property under a number of stipulated taxing provisions[14].

Excluded transactions

8. Before the disposal or contribution conditions are satisfied in relation to land or chattels the transaction in question must not be an excluded transaction. The excluded transactions are listed at paragraph 10. Perhaps the most important excluded transaction is paragraph 10(1)(a), which provides that, for the purposes of the disposal condition, if the transaction is made at arm's length with an unconnected person, or by a transaction of the type that might be expected to be made by persons acting at arm's length who are unconnected, then the transaction will be excluded. Of the other excluded transactions, perhaps the most contentious is that transferring property to, or contributing consideration to the purchase of a property by, a spouse is excluded. The Joint Committee on Human Rights in its report on the Bill highlighted the invidious nature of this exclusion, because even though "spouse" is not defined in the legislation

---

11 Paragraph 1.

12 Income and Corporation Taxes Act 1988 ("ICTA 1988").

13 Paragraph 8(1)(b) adds the further restriction that the income must be so treated even if subsection (2) of that section did not include any reference to the spouse of the settlor.

14 Paragraph 9(1) lists the relevant provisions: ss 547, 660A, 739 ICTA 1988 and ss 77, 86 Taxation of Chargeable Gains Act 1992

it has been interpreted as meaning "parties to a lawful marriage"[15]. This means that couples who are in a similar relationship as a married couple, but for some reason are not married, would not be covered.

Exemptions from charge

9. Paragraph 11 contains a number of exemptions. The principal exemption is where the relevant property[16] or other property deriving its value from the relevant property, is included in the taxpayer's estate. The other exemptions are fairly straightforward. However there is some ambiguity in paragraph 11(5)(d). Paragraph 11(5) exempts property which is subject to a reservation of benefit, and property which would be subject to a reservation of benefit but for certain stipulated provisions of the Finance Act 1986 ("FA 1986"). Of particular interest is paragraph 11(5)(d), which exempts property which would fall to be so treated "*but for section 102C(3) of, and paragraph 6 of Schedule 20 to, the [Finance Act 1986]*" (my emphasis). The key question relates to the emphasised "and": do both of these provisions have to be satisfied before the exemption applies? The author's view is that they do not. The subparagraph in question relates to when property would be subject to a reservation but for the two provisions in question. Therefore the question being posed by paragraph 11(5)(d) is in two stages. First would a reservation of benefit apply in normal circumstances to the present case? If the answer is yes, the next question is whether, if it does not apply, the reason it does not apply is because of the provisions in question. Put another way, the "and" is used to stress that both provisions are to be taken into consideration when deciding whether the reason the GROB rules do not apply is a permitted one.

10. Whilst the author can see the opposite argument, that the circumstances at hand must fall into both of the exemptions from the GROB rules before the exemption can apply, the author's interpretation makes sense of the provisions. Schedule 20 paragraph 6(1)(a) FA 1986 relates to the GROB rules being disapplied where an interest in land or a chattel has been disposed of and the disponor's occupation of the land, or actual possession of the chattel, is for full consideration. Section 102C(3) FA 1986 says no account should be taken of occupation of land which

---

15 Joint Committee on Human Rights (Twelfth Report) paragraph 1.56

16 Relevant property is defined in paragraph 11(9) as meaning, in relation to paragraphs 3 and 6 the property which is the subject of the disposal or contribution condition and in relation to paragraph 8 the property so defined in that paragraph.

satisfies the conditions in Schedule 20 paragraph 6(1)(b) FA 1986. This condition is essentially where occupation is due to a change of circumstances which mean that the donor needs care and maintenance due to old age or infirmity from a relative or his spouse. Put these two provisions together and the exemption in paragraph 11(5(d) only applies where the donor occupies land (and land alone, despite paragraph 6(1)(a) mentioning chattels) because of his old age and infirmity, and in order to receive care and maintenance from a relative or his spouse, and yet is still able to pay full consideration for his occupation. This restricts the exemption to such an extent that in the author's view it makes a nonsense of it. Therefore the simplest solution is to read "<u>and</u>" as meaning "<u>or</u>", and it is understood that the Revenue accept this interpretation.

10. If the author's view is right then whenever a taxpayer pays full consideration for occupation of land, or the possession or use of a chattel, then he will be exempted from any income tax charge. This will be especially important for those renting chattels, as the full consideration is likely to be quite low. It has been suggested that the Revenue might take the view that there is no market for renting chattels and that, in the absence of any market, it is impossible to determine what constitutes full consideration[17]. The fact that professional valuers are able to put a rental price on chattels would seem to disprove the contention that it is "impossible" to determine what the full consideration for chattels is. Further, it would be otiose to include chattels within Schedule 6(1)(a) if it could never actually apply in relation to them. In any event, you only have to ask whether full consideration is in fact being paid for the chattels. If a professional valuer can put a price on what that full consideration is, it would be no defence for the Revenue to rely on the absence of a market place for those chattels: that does not alter the fact that a full consideration is being paid.

The Schemes

11. As already mentioned, Schedule 15 is designed to attack a number of schemes which have been widely used to escape the GROB rules. The question is therefore, has the Schedule achieved its aim? The first scheme to consider is the *Eversden*[18] scheme. In brief outline, the scheme involves settling assets on trust for your spouse, who has an interest in possession in the assets for life or for three months, whichever is shorter.

---

17 B. McCutcheon, *Taxation*, 16th September 2004 pp 626-629

18 *IRC v Eversden and anor (exors of Greenstock, decd)* [2002] STC 1109

After the expiry of the wife's interest in possession the assets are to be held on discretionary trusts for a class of beneficiaries including the settlor and his wife. This arrangement will now be caught by the new provisions because the taxpayer will occupy the property, and the disposal condition will be satisfied. Disposals by way of gift, by virtue of which the property becomes settled property in which the spouse as an interest in possession, are excluded transactions[19], however the transaction will stop being so treated if the spouse's interest in possession comes to an end other than on death[20]. Therefore whilst the disposal will initially be an excluded transaction, once the spouse's interest in possession expires, the transaction will stop being excluded. Further, the reason why the original transfer is not caught by the GROB rules is because of s.102(5)(a) IHTA 1984, which is not

12. Another very popular device is the home loan scheme. This typically involves the establishment of two trusts, a Home trust and a Debt trust. The settlor and his spouse have interests in possession in the Home trust and are excluded from the Debt trust, which is for the benefit of his children. The land in question is sold to the Home trust, in return for a loan note, which is settled on the Debt trust. The idea is that the loan note significantly depreciates the value of the land held on trust. Therefore it does not matter that the land will be included in the value of his estate by virtue of his life interest in the Home trust (s.49 IHTA 1984). Whilst it might be thought that the home loan scheme would fall within the exemption in paragraph 11(1), as the relevant property (in this case the land) does fall within the value of his estate, because the value of his estate is reduced by an excluded liability which affects the land, the exemption does not apply[21].

13. Another device which I believe is caught is the reversionary lease scheme. Whilst under the reversionary lease scheme there is no disposal of the land as such, paragraph 3(4) provides that the creation of a new interest in land out of an existing interest in land is considered to be a disposal of part of the existing interest, and therefore the scheme will be caught. This cannot be an excluded transaction because, even if it was an arms length transaction or a transaction which might be expected to be

---

19 Paragraph 10(1)(c)

20 Paragraph 10(3)

21 Paragraph 11(6). The definition of excluded liability is in paragraph 11(7), which in the author's view covers the home loan scheme because the creation of the loan note and the sale of the property to the Home trust are associated operations.

made at arms length, it is not the disposal of the whole of the taxpayers interest. The only possible argument would be that the creation of a reversionary lease is in fact the disposal of the whole of the taxpayer's interest in the land. This is a technical land law argument which is outside the scope of this article, but it remains a possibility as an argument of last resort.

14. Finally, the *Ingram*[22] scheme will be caught, because there will have been the creation of a new interest in the land, which counts as a part disposal, and the taxpayer will continue to be in occupation.

Remaining Issues

15. There are a number of remaining issues raised by the legislation. The first is the seemingly retrospective nature of the Schedule. The Schedule applies, for example, to disposals of land which were made after 17th March 1986. Therefore it may be said that the legislation is taxing arrangements which were not taxable when they were entered into, and it could not be foreseen that they would become taxable. Whilst not wishing to get involved in a lengthy analysis of this view from a Human Rights law perspective, the author finds himself in agreement with the Joint Committee on Human Rights, who, having looked at the legislation, formed the opinion that it was not retrospective, and therefore could not be in breach of any fundamental rights[23]. The main point is that the tax is on benefits received from occupying the land. The tax is not on benefits which may have been received in the past, it is only a tax on benefits received from the commencement date (1st April 2005) from continuing occupation of the land[24]. Therefore if the taxpayer ceases occupation of the land the provisions will no longer apply to him. The other alternative open to the taxpayer is to elect to have the inheritance tax provisions apply to the property in question, and there are detailed rules in paragraphs 21 to 23 on how to do this.

16. The other remaining issue concerns how schemes could be potentially unwound. One possible avenue for unwinding schemes which involve land or chattels is for the assets to be resettled on trust for the taxpayer,

22 *Ingram v IRC* [1999] STC 37

23 In particular Protocol 1, Article 1 of the European Convention on Human Rights, which prohibits interference with the peaceful enjoyment of property, but which has a let out for lawful taxation.

24 See paragraph 1.49 of the report

and therefore the value of the assets would be included within his estate, and the exemption in paragraph 11(1)(a) would apply. This would be acceptable, however at this point the taxpayer may wish to give away his property, this time under an excluded transaction. The author's view is that at this point paragraph 3 would still apply to the taxpayer if he remains in occupation of the land. This is because he would still have disposed of his interest in the land after 17th March 1986 otherwise than by an excluded transaction (the same would apply for the contribution condition). There is nothing in the legislation to say that, because he has disposed of his interest in the land a second time, this time by way of an excluded transaction, the paragraph no longer applies. This will present some difficulties for those attempting to unwind schemes.

Conclusions

17. Schedule 15 represents a radical addition to an already complicated tax system. A good understanding of how it works is from now on going to be essential for anyone involved in personal tax planning. The author hopes that this article will help in providing an outline of how the provisions work, as well as highlighting the key issues.