

Bulletin

Pre-Owned Assets

Setting the scene

Inheritance tax (IHT) was introduced almost 20 years ago and broadly charges to tax certain lifetime gifts of capital and estates on death.

With IHT came the concept of 'potentially exempt transfers' (PETs): make a lifetime gift of capital and, so long as you live for seven years from making the gift, there can be no possible IHT charge on it whatever the value of the gift. The rules create uncertainty until the seven year period has elapsed but, at the same time, opportunity to pass significant capital value down the generations without an IHT charge. Of course this is to over simplify the position and potentially ignore a whole host of other factors, both tax and non-tax, that may be relevant.

However many people are simply not in a position to make significant lifetime gifts of capital. There are a number of reasons for this the most obvious being that their capital is tied up in assets such as the family home and business interests and/or it produces income they need to live on.

But what is to stop a gift of the family home being made to, say, your (adult) children whilst you continue to live in it? The answer is simple: nothing! However such a course of action is unattractive not to say foolhardy for a number of reasons the most significant being:

- security of tenure may become a problem
- loss of main residence exemption for capital gains tax purposes
- it doesn't actually work for IHT purposes.

The reason such a gift doesn't work for IHT is because the 'gift with reservation' (GWR) rules deem the property to continue to form part of your estate because you continue to derive benefit from it by virtue of living there.

However this is not the end of the story.....

Getting around the rules

To get around the GWR rules a variety of complex schemes were developed, which allowed continued occupation of the family home whilst effectively removing the equivalent value from the IHT estate. For an individual with a family home worth say £500,000 the prospect of an ultimate IHT saving of £200,000 (being £500,000 x 40%) was an attractive one.

The Revenue's response

Over time most schemes were tested in the courts and blocked for the future.

However the Revenue wanted to find a more general blocking mechanism. Their approach has been somewhat unorthodox with the GWR rules remaining as they are. Instead a new income tax charge is levied on the previous

owner of an asset if they continue to be able to enjoy use of it. The new rules are referred to as the Pre-Owned Assets (POA) rules. They are aimed primarily at land and property but also apply to chattels and certain interests in trusts.

Scope

In broad outline, the rules apply where an individual successfully removes an asset from their estate for IHT purposes (ie the GWR rules do not apply) but is able to continue to use the asset or benefit from it.

Example 1

Ed gave his home to his son Oliver in 1999 by way of an outright gift and Ed continues to live in the property.

This is not caught by the POA rules because the house is still part of Ed's IHT estate by virtue of the GWR rules.

Example 2

As example 1 except that Ed entered into a 'scheme' the effect of which was to remove the value of his home from his IHT estate. Ed continued to live in the property. This is caught by the POA rules. Even if Ed did not live in the property full-time because, say, it is a holiday home the rules would still apply.

The rules also catch situations where an individual has contributed cash towards the purchase of property from which they later benefit unless either:

- the gift of cash was made before 6 April 1998 or
- the gift of cash was made after 5 April 1998 and there is a gap of more than seven years between the gift and occupation of the property.

Example 3

In 1999 Hugh made a gift of cash to his daughter Caroline. Caroline later used the cash to buy a property which Hugh then moved into in 2004. The POA rules apply.

The rules would still apply even if Caroline had used the initial cash to buy a portfolio of shares which she later sold using the proceeds to buy a property for Hugh to live in.

There are a number of exclusions from the new rules, one of the most important being that transactions will not be caught where a property is transferred to a spouse or former spouse under a court order.





Start date - retrospection?

Despite the fact that the new regime is only effective from 6 April 2005, it can apply to arrangements that may have been put in place at any time since March 1986. This aspect of the new rules has come in for some harsh criticism. At the very least it means that pre-existing schemes need to be reviewed to see if the new charge applies.

Calculating the charge

The charge is based on a notional market rent for the property.

Example 4

Assuming a rental yield of, say, 5%, the income tax charge for a higher rate taxpayer on a £1 million property will be £20,000 each year.

- The rental yield or value is established assuming a tenant's repairing lease.
- Properties need to be valued once every five years. In situations where events happened prior to 6 April 2005, the first year of charge is 2005/06 and the first valuation date is 6 April 2005 with the next valuation due on 6 April 2010.
- The charge is reduced by any actual rent paid by the occupier – so that there is no charge where a full market rent is paid.
- The charge will not apply where the deemed income in relation to all property affected by the rules does not exceed £5,000.
- The rules are more complex where part interests in properties are involved.

Avoiding the charge

There are a number of options for avoiding the charge where it would otherwise apply.

- Consider dismantling the scheme or arrangement. However this may not always be possible and even where it is, the costs of doing so may be prohibitively high.

- Ensure a full market rent is paid for occupation of the property - not always an attractive option.
- Elect to treat the property as part of the IHT estate.

The election

The effect of the election using example 4 above is that the annual £20,000 income tax charge will be avoided but instead the £1 million property is effectively treated as part of the IHT estate and could give rise to an IHT liability of £400,000 for the donee one day. Whether or not the election should be made will depend on personal circumstances but the following will act as a guide.

Reasons for making the election

- Where the asset qualifies for business or agricultural property reliefs for IHT.
- Where the value of the asset is within the IHT nil rate band even when added to other assets in the estate.
- Where the asset's original owner is young and healthy.

Reasons not to make the election

- The life expectancy of the donor is short due to age or illness and the income tax charge for a relatively short period of time will be substantially less than the IHT charge.
- The amount of the POA charge is below the £5,000 de minimis.
- The donor does not want to pass the IHT burden to the donee.

The election must be made by 31 January in the year following that in which the charge would first apply. In other words if it would apply for 2005/06 the election must be made by 31 January 2007.

What now?

The new rules undoubtedly make effective tax planning with the family home more difficult. However they do not rule it out altogether and the ideas we mention below may be appropriate depending on your circumstances.

Sharing arrangements

Where a share of your family home is given to a family member (say an adult child) who lives with you, both IHT and the POA charge can be avoided. The expenses of the property should be shared. This course of action is only suitable where the sharing is likely to be long term and there are not other family members who would be compromised by the making of the gift.

Equity release schemes

Equity release schemes whereby you sell all or part of your home to a commercial company or bank have been popular in recent years. Such a transaction is not caught by the POA rules.

If the sale is to a family member, a sale of the whole property is outside the POA rules but the sale of only a part is caught if the sale is on or after 7 March 2005.

The cash you receive under such a scheme will be part of your IHT estate but you may be able to give this away later.

Wills

Wills are not affected by the new regime and so it is more important than ever to ensure you have a tax-efficient Will.

Consider Mr and Mrs Smith. They both have assets worth £275,000 made up of the family home in which each of them owns a half share and various investments. Mr Smith dies first and leaves everything to his wife. There will be no inheritance tax to pay at this stage because gifts between spouses are exempt. Mrs Smith dies two years later worth £550,000. Her estate passes to the children and the inheritance tax payable at current rates amounts to £110,000. The liability arises because Mr Smith's 'nil rate band' of £275,000 was not used on his death.

There is a way of leaving all of your wealth directly to a spouse on death which still enables use of the £275,000 nil rate band. It can be done by each spouse writing a tax efficient Will including a discretionary Will trust with a 'debt-charge' arrangement. Such a Will is sometimes referred to as a Loan Plan Will. In essence the plan works by leaving everything to the surviving spouse as before but in addition leaving £275,000, typically in the form of a charge on the house, to a discretionary trust. On the death of the first spouse there is no inheritance tax liability. On the death of the second spouse, his or her estate is reduced by the £275,000 owed to the trust. Such an arrangement for Mr and Mrs Smith would save the whole £110,000 inheritance tax liability. The children then inherit everything free of tax when Mrs Smith dies but she has had use of all the assets without restriction during her lifetime.

Summary

This is a complex area and professional advice is necessary before embarking on any course of action. The new POA rules are limited in their application but having said that they have the potential to affect transactions undertaken as long ago as March 1986.

Please get in touch if you have any questions arising from this bulletin or would like specific IHT planning advice.