

Pre-owned assets: Budget update

The annual income tax charge on 'pre-owned assets' was introduced in the Finance Act 2004 and this was designed to either collect tax each year from all those who had previously entered into inheritance tax planning schemes or alternatively force them to unwind the schemes thereby reinstating the inheritance tax liability.

Unfortunately the legislation is notoriously difficult to apply in practice. The annual income tax charge is based on the rental value of a property, but in practice this can be difficult to determine with any accuracy. It is deemed letting, warts and all, of the property unfurnished and often not suited for the letting market.

Disregarding problems of this type, there is still uncertainty as to how the legislation applies to various different types of scheme. For example, a parent may have sold his property to his wealthy son who was able to find the purchase price out of his own cash resources. Some time later, the parent could then give the son the cash received as a lifetime gift. One might expect the pre-owned asset rules to apply here but do they? To be caught, the parent must have directly or indirectly provided the consideration for the purchase of the property by the son, but the son will say that he financed it entirely out of his own resources. The gift of cash by the parent might have been months later or many years later; does it make any difference if it was soon after the transaction or years after it?

The double trust planning idea in respect of a person's main residence was based on the concept of selling the property to a trust for yourself which would owe you the purchase price and you could then give away the debt owed by the trust to your children, or more likely to a trust for their benefit. It is often assumed that the simple solution now is to be to make the election back into inheritance tax which is provided for in the pre-owned asset legislation. Instead of unwinding the scheme, the taxpayer simply elects not to pay the income tax liability, but instead to treat the subject matter of the scheme as remaining in his inheritance tax estate. Unfortunately, this may not be advisable. The view of HMRC is that in these circumstances the election adds the full value of the property in the scheme back into the taxpayer's estate, and this is *additional* to the value of the property less the debt charged on it (in favour of the children or a children's trust) which is also in the taxpayer's estate on ordinary principles. As the value of the property rises in excess of the amount of the debt, this means that the inheritance tax election will clearly give rise to double inheritance tax liability. This is an extraordinary interpretation of the various statutory provisions and it rules out making the election in most cases.

This year's Finance Bill has now thrown an additional ingredient into the mix. Under the legislation as originally drafted, it was necessary to make the inheritance tax election within a strict time scale and after that one would have to persuade a sceptical Tax Inspector that there was a good reason for making it out of time. The Finance Bill includes a clause which appears to

have the effect of making late elections more generally acceptable, even without any particular excuse being available for the lateness. More guidance on how this new provision will be operated is awaited, but it now seems to be the case that the taxpayer can 'wait and see' as to whether it is advantageous to make an election in any particular case. For example, in the first of the two steps described above – the sale of the home to the son – the taxpayer can now take the view that his scheme is not caught by the legislation and not therefore make the election at this stage. If at some time in the future it is found that his view is correct, perhaps because another taxpayer successfully appeals the point, he will have preserved all the benefits of the scheme and will be home and dry. If on the other hand the future appeal case decides otherwise, he could perhaps then make the election if it suited the case, thereby retrospectively eliminating all past pre-owned asset income tax liabilities, but at the cost of reinstating the inheritance tax liability.

With the 'double trust' planning idea, we might similarly get some guidance from a future appeal case as to how the legislation actually applies to it, or what the true impact of the election is when it is made to take the taxpayer out of the income tax charge in respect of the scheme. There will now be less of a downside if the election is left in abeyance until such a case surfaces in the future.

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