MATTERS ON WHICH HMRC VIEW IS SOUGHT IN RELATION TO PRE-OWNED ASSETS INCOME TAX. PAPER SUBMITTED ON BEHALF OF STEP, CIOT AND LITRG.

14 July 2005. *STEP, CIOT, LITRG questions to HMRC.*

Note—

The questions were submitted by the Society of Trust and Estate Practitioners, the Chartered Institute of Taxation and the Low Income Tax Reform Group on 14 July 2005. Where replies have been received from HMRC they are included. Answers as revised on 12/3/06.

SUMMARY OF QUESTIONS

Valuation issues

(1) Moving **properties**.
(2) Calculation of POAT on home loan schemes.
(3) Reduction of debt on home loan scheme.
(4) Calculation of POAT charge where mix of intangibles/house on home loan schemes.
(5) Discounts on DV.
(6) Commercial group life policies.
(7) Partnership life policies.
(8) Pension life policies.
(9) Pre-1986 life policies.
(10) Scope of Reg 6: election and home loan schemes/double charges.

Home Loan Schemes

(**11**) **11**. Assigning debt back to settlor
(12) **Valuing** the excluded liability.
(13) Commercial borrowing by trust.
(14) Reservation of benefit on loan. Does POA apply?
(15) **Which** home loan schemes work?

Election

(16) Election by one spouse only.
(17) Effect of election on home loan schemes and s102(4).
(18) Spouse exemption and home loan schemes.
(19) New elections on change of **property**.

(20) Life interest settlor interested trusts and **para** 8.
(21) Elections on home loan schemes – whole house or only on debt part.
(22) Elections where only part of gifted **property** caught.
(23) Late elections.
(24) Wrong payment of income tax.

Equity release.

(25) Regulation 5 and part disposals. Promissory estoppel.
(26) Definition of RCAs
(27) Sales of whole.
(28) Carving out a lease.

Reversionary leases.

(29) Paying rent under legal obligation.
(30) HMRC policy on reversionary leases.

Miscellaneous

(31) 31. Disposal and contribution conditions.
(32) Meaning of "provision" and loans. The contribution condition.
(33) Occupation of house owned by company funded by loan.
(34) Overdrawn discounts.
(35) "Outright gift to another person" – **para** 10(2)(c).
(36) Partnerships and POAT.
(37) Annual exemption.
(38) Interaction of ROB/POAT and full consideration.
(39) **Para** 10(3). Spousal interest in possession. Spouse becomes absolutely entitled.
(40) Meaning of occupation.
(41) Non-exempt sales.

Foreign domiciliaries

(42) Interaction of **paras** 12(3) and **11**.

***Para** 8 charge*

(43) Reverter to settlor trusts holding intangibles.
(44) Intangibles and the election.

In this paper we raise a number of questions of principle illustrated by a specific example. For ease of reference we number the questions on **which** a specific response is sought.

1. **Valuation issues**

1.**1** Regulation 4 provides **that** in relation to land and chattels the valuation is by reference to the first valuation date and this valuation is used for a period of 5 tax years. This is favourable to taxpayers where the gifted land increases in **value**. For instance, in relation to existing Ingram and reversionary lease schemes, one takes the **value** of the gifted **property** as at 6th April 2005 even though the gifted interest (the DV) is likely to increase in **value** over the next 5 years. However, the position is unclear where the **property** is sold and the taxpayer moves to a smaller house.

Example 1

A gave £300,000 to his son in April 2000. Son later uses all the cash to purchase a house and contributes none of his own funds. A goes into occupation of house in April 2002. He falls within the contribution condition and is subject to the POA charge from 6th April 2005. The house is worth £1 million on 6th April 2005. He pays income tax in 2005/6 by reference to the rental value of the house.

In 2007 Son sells house and buys a new one for £500,000 into which A moves. In these circumstances there seems to be no mechanism for assessing A to income tax on the rental value of the new house.

Does A continue to pay income tax on a hypothetical rental value of the original £1 million house until 2010?

Similar problems can arise if A moves into a discrete part of the house and only occupies that part, letting the remainder. If he has not done this by 6th April 2005 it would appear that his charge is not reduced for the next 5 years.

Question 1

Do HMRC interpret the legislation in this restrictive way or do they take the view that the relevant land for the purposes of para 4(5) is the land that the taxpayer actually occupies and therefore a new valuation is done when the taxpayer first occupies the smaller property or the smaller part? This is on the basis that a new taxable period then starts in which that property or part is the relevant property. The Regulations would then apply on the basis that the first day of such occupation is the first day of the taxable period.

HMRC answer to question 1

The "relevant land" for the purposes of paragraph 4(5) is the land currently occupied by the chargeable person. A new valuation should be done when the occupation of that property starts, and we would intend that the new valuation should then be used for the remainder of that 5-year cycle.

1.2 Particular valuation problems arise in relation to the double trust or home loan schemes.

Example 2

B sells his house to a trust in which he retains an interest in possession ("the property trust") and the purchase price of £900,000 is left outstanding as a debt. B gives away the debt. Assume that B is caught by POA and that the debt is an excluded liability. The house is worth £1 million on 6th April 2005 and the debt is £900,000. Based on HMRC's example in the Appendix of the Guidance Notes, B pays income tax on 9/10 of the rental value attributable to the house.

Question 2

Can HMRC confirm that this is the view taken? ie that where the debt is only a percentage of the value of the house the taxpayer pays income tax on the same percentage of the rental value?

There seems no express provision in para 11 to allow for a percentage reduction in the charge in the event that the property is subject to a debt but has some excess value. We assume from the example in the Appendix that HMRC interpret the interaction of paras 11(6) and (1) and in particular the words "to the extent that" to mean that if the value of the property exceeds the excluded liability by 10% there is a 10% reduction in the charge under para 4.

HMRC answer to question 2

We confirm that, where, as in Example 2, the debt is only a percentage of the value of the chargeable property, income tax is payable on the same percentage of the rental value. As you suggest, this follows from the interaction of paras. 11(6) and (1). As far as subsequent valuation cycles are concerned, we would adjust the proportion of the rental value charged to reflect any adjustment to the value of the chargeable property.

1.3 If the debt was reduced to £500,000 (by partial repayment or by writing off) then it would appear that B would pay income tax from that date on half the rental value of the property and that Regulation 4 does *not* prevent a reduction in the income tax charge on repayment of the debt even if this is done half way through the five year period. Half the value of the property is now deemed to be comprised in the person's estate under para 11(1) and there is no charge on this part.

Question 3

Can HMRC confirm **that** if the debt "affecting" the **property** is reduced for any reason the income tax charge reduces by the same proportion even if this reduction occurs during the five year period?

Suppose in the above example the home loan scheme had been effected by a married couple H and W but only H later added the £500,000 to the **property** trust to enable the **property** trustees to repay part of the loan. Are we correct to assume **that** the loan is pro rated so **that** the excluded liability is reduced for H and W by £250,000 each rather than the repayment just reducing H's **share** of the excluded liability?

HMRC answer to question 3

We confirm **that** the income tax charge **would** be reduced by the same proportion by **which** the debt affecting the **property** was reduced. In view of the reference in paragraph **11**(6) to "at any time", we confirm **that** the charge **would** be reduced even if the reduction of the debt occurred during the 5-year period.

Where the scheme had been effected by a married couple, H & W, we assume **that** the answer **would** depend on the precise terms of the **property** trust. But, assuming **that** the **property** is held by H & W equally, the addition by H of £500,000 to the trust **would** diminish his estate by £250,000 (an exempt transfer to W). On **that** basis, we **would** agree **that** the excluded liability for H & W **would** be reduced by £250,000 each.

1.4 Suppose **that** the house is sold by the **property** trust and the trustees then purchase a smaller **property** for say £600,000. The debt of £900,000 is **not** repaid but left outstanding and the spare cash of £400,000 is invested in intangibles to produce an income for B. On a literal reading of Regulation 4 it **would appear that** B still pays income tax on the market rental of the original **property** as at the April 2005 valuation (reduced by one tenth).

Question 4

We assume **that** HMRC consider **that** once a smaller **property** is purchased during the five year period, what is **valued** for the purposes of the POA charge under **para** 4 is indeed **that** smaller **property**. Please confirm.

HMRC answer to question 4

Assuming **that** the intangibles are held on the original trusts and **that** the debt of £900,000 is left outstanding, we agree **that** the smaller **property would** be within the charge under paragraph 4 and **that** the intangibles **would** come within paragraph 8.

In line with the answer to Q1, we **would** suggest **that** the paragraph 4 computation should be based on the **value** of the newer, smaller **property** with the intangible **property** being charged under paragraph 8. The parts chargeable under paragraphs 3 (as quantified in accordance with paragraph 4) and 8 should then be arrived at by apportioning the loan rateably between the two components. However if the loan was originally secured specifically on the land, one **would** calculate the paragraph 3 charge simply by reference to the **value** of the new, smaller **property** with the balance of the loan being charged under paragraph 8.

1.5 Suppose husband has given away his 50% **share** in the home originally owned jointly with his wife. The gift was into an Eversden settlement and is now caught by POA. In these circumstances, professional surveyors consider **that** the 50% **share** should be discounted and hence "the DV" figure be reduced.

Questions of valuation are **not** specifically addressed in the Guidance Notes but we assume **that** HMRC accept **that**, if professionally so advised, a discount for joint ownership **would** be appropriate for the DV figure.

Question 5

Can a standard percentage discount be agreed with HMRC in relation to jointly held interests?

HMRC answer to question 5

We agree **that** the 50% **share** of the house chargeable under POA should be **valued** on normal open market principles for the purposes of ascertaining DV. This **would** imply a discount, but **not** sure **that** we can agree a standard discount in advance, any more than we **would** do for "normal" IHT purposes.

1.6 There are difficulties in **valuing** settled insurance policies caught by **para** 8. For example, in their Guidance Notes HMRC take the view **that** life policies settled on a commercial basis by partners or shareholders for each other will be caught under POA if the settlor retains an

interest. The settlor will often retain such an interest since there is usually a provision that the life policy will revert to the business owner if he leaves the business before death.

Question 6

In these circumstances how does one value the intangible property?

Would it be based on the surrender value of the life policy?

HMRC answer to question 6

Our current view is that a group policy taken out for the partners or shareholders is within the scope of the paragraph 8 charge, because each partner, as settlor, is not excluded from benefit. This appears to be the case whether or not each partner can benefit on leaving the partnership and whether or not the only benefits that can accrue to a partner are those arising on the death of a partner. As far as valuation is concerned, we would expect the value of the policy to be its open market value at the relevant time, not its surrender value.

1.7 The comments on life policies taken out by partnerships and other businesses contained at the end of the revised Guidance Notes seem to go directly against Government policy which is to encourage such arrangements (as illustrated by the relieving legislation introduced in FA 2003 s 539A for income tax purposes).

Question 7

Are HMRC considering an extra statutory concession to relieve such arrangements from the POA charge?

This would appear to be appropriate given that such arrangements are commercial with no donative intent and therefore outside the reservation of benefit provisions.

If the only interest of the settlor in the trust is that the life policy reverts to the settlor if he leaves the business before his death, do HMRC agree that the settlor's interest under such arrangement can be regarded as similar to his interest under discounted gift schemes and therefore outside the POA charge – see 8.1?

HMRC answer to question 7

An Extra Statutory Concession is not in view, as far as we are aware, and we do not think it is for us to comment on whether one would be appropriate. As far as the settlor's interest in the policy is concerned, We are doubtful that there is an exact analogy with Discounted Gift Schemes as you suggest. While this would depend on the terms of the policy concerned, it is not clear to us that the value of the settlor's contingent interest and the value of the interests of the surviving partners can be sufficiently distinguished in the way that we have agreed they can be for Discounted Gifts.

1.8 We should be grateful for some clarification of HMRC policy in respect of pension policies (whether retirement annuity or personal pension policies and whether approved or unapproved). Typically such policies provide that retirement benefits and other lifetime benefits such as a payment on demutualization are held for the absolute benefit of the individual member with death benefits being held on discretionary trusts.

Question 8

Do HMRC take the view that the analysis on such policies is similar to discounted gift schemes and that the retirement benefits represent separate unsettled property? See 8.1. Can HMRC confirm that the POA Regime does not apply to such pension arrangements? Does their view change if the individual member can benefit from the discretionary trust over the death benefits?

HMRC answer to question 8

(a) As a general rule, the pension and other lifetime benefits for the scheme member and the benefits paid on death are mutually exclusive. On this basis, we would agree that an analogy can be drawn with discounted gift schemes so that the pension benefits would either represent unsettled property or a trust separate from that on which the death benefits are held.

(b) On the basis of the above, we would agree that the POA regime would generally not apply to pension arrangements, where the individual scheme member was not able to benefit from the discretionary trust governing the death benefits.

1.9 Valuation problems arise where a settlor takes out a life policy and writes it on trust pre-18 March 1986. The reservation of benefit rules did not apply then and so he is often a potential beneficiary. Suppose that for the last 20 years he has been paying the premiums on such policy. Section 102(6) FA 1986 provides an exemption from reservation of benefit in respect of

premiums paid post 17 March 1986 where the policy was taken out before 18 March and the premiums increase at a pre-arranged rate. However, there has been concern that premiums paid post 17 March 1986 would appear to be within the POA Regime.

Question 9

Do HMRC consider that such policies are caught? We would suggest that premiums paid since 17 March 1986 are not themselves additions to the settled property if paid direct to the insurance company but merely maintain the value of the settled property and therefore are not strictly within the wording of para 8.

We understand from correspondence in Taxation that HMRC believe POA does apply and apportion the premiums between pre 18 and post 17 March 1986.

In the light of the comment in (a) above will HMRC reconsider their views in respect of payments on such policies?

HMRC answer to question 9

In our view, it is correct to regard premiums paid after 17 March 1986 in respect of settled policies as additions to the settled property and so within paragraph 8 if the settlor is a potential beneficiary. As you suggest, the proportion of the settled property chargeable under paragraph 8 is arrived at by apportioning the premiums between those paid pre- 18 and post-17 March 1986.

2. **Home loan or double trust schemes**

We have a number of specific queries on home loan schemes and would welcome clarification with regard to the following points.

2.1 We welcome the provision for the avoidance of a double charge in the event of the GWR election being made. However, as discussed below, the election still has a number of uncertainties. Furthermore Regulation 6 is defective in a number of respects.

Firstly, it should not be limited to gifts into settlements (see Regulation 6(a)(ii)) since in some cases the gift of the debt was outright to a child rather than into trust.

2.2 Secondly, Regulation 6 should not be limited to a gift of property representing "the proceeds of the disposal of relevant property".

Many schemes proceeded on the basis of taxpayers lending money to the trustees by a loan agreement and the trustees then using that money to buy the house. The loan does not represent the proceeds of the house. There should be relief in these circumstances.

Question 10

Will HMRC in practice apply Regulation 6 to relieve all home loan schemes from a potential double charge where the donor has died having made an election or is Regulation 6 being amended to cover the above points?

HMRC answer to question 10

We note your view that Regulation 6 of SI 2005/724 is not wide enough to cover all cases where a double charge may arise after the taxpayer has elected. At this stage, we cannot give an assurance that we will apply the regulation more widely than its terms indicate, but we will pass on your views on this point.

2.3 One of the ways that taxpayers are unravelling home loan schemes is to appoint the debt to the children who then assign it back to the settlor thus losing all inheritance tax benefits but at least ensuring (provided that the children took interests in possession under the original trust) that if the settlor dies within 7 years of the original PET, there is relief under the Double Charges Regulations. (This course is often preferable unless double charges relief is to be given for the release of a debt.)

Although there is still an excluded liability in existence, the excluded liability does not appear to be relevant any longer in that it does not reduce the value of the parents' estates under paragraph 11(6) albeit it affects the value of the house. The wording in para 11(6) refers "to the value of the person's estate" and we assume that this means the value of someone's total estate for inheritance tax purposes.

Therefore the fact that the loan continues to reduce the value of the house does not mean that the loan is caught under para 11(6).

Question 11

Is the analysis in 2.4 correct (a) in stating **that** there is relief under the Double Charges Regulations if the children assign the debt back to the settlor and the settlor dies within 7 years of the original gift of the debt and (b) **that para 11**(6) is no longer in point once the assignment has been effected back to them because the debt no longer reduces the **value** of their estates?

HMRC answer to question 11

We agree with your analysis in paragraph 2.4(a): the circumstances you have in mind seem to be covered by Regulation 4 of SI 1987/1130. As far as paragraph 2.4(b) is concerned, we agree **that** paragraph **11**(6) **would** no longer be in point.

2.4 **Para 11**(6) refers to "the amount of the excluded liability". We seek clarification as to whether this is the face **value** of the debt (including any rolled up interest or accrued indexation) or the commercial **value** of the debt.

Example 3

C entered into a home loan scheme. The house is worth £2 million and the debt is repayable on C's death, is linked to the RPI and has a face **value** of £**1**.9 million. Its commercial **value** is discounted due to the fact **that** it is **not** repayable until C's death. Allowing for the fact **that** the debt is linked to the RPI, its market **value would** be, say, £**1**.2 million but increasing.

In these circumstances the question is, whether the excess **value which** is treated as part of C's estate and therefore **protected** from the POA charge under **para 11(1**) is:

(i) £100,000

(ii) £800,000 or

some other figure such as £100,000 less accrued indexation?

Question 12

What is HMRC's view regarding the amount of the excluded liability in the above scenario?

It **would appear that** the correct view is to take the commercial **value** of the debt as reducing the person's estate because in reality the **property** is "affected" by this amount of debt. Obviously the POA charge **would** become higher as the commercial **value** of the debt increased towards the end of the donor's lifetime and hence less **property** exceeded the **value** of the debt.

HMRC answer to question 12

In our view, the fact **that** paragraph **11**(6) refers to the "amount" of the excluded liability indicates **that** it is the face **value** of the debt, including any rolled-up interest or accrued indexation, **that** is relevant. In practice, we **would** only seek to adjust the **value** of the debt to take account of interest and indexation at the 5-yearly valuation dates, though we **would** be prepared to allow any reduction of the debt resulting from any repayment be taken account as it occurred and to be reflected in a revised computation of tax in the relevant year and subsequently.

2.5 A common scenario (both for foreign and UK domiciliaries) is where cash is settled into an interest in possession trust for the donor life tenant. The trustees then buy a house for the donor to live in using the gifted cash plus third party borrowings. Although **not** a home loan scheme, the legislation **appears** to affect such arrangements.

Example 4

E settles cash of £200,000 into an interest in possession trust for himself in 2003. The trustees purchase a **property** worth £500,000, borrowing £300,000 from a bank. There are other assets in the trust **which** can fund the interest but the borrowing is secured on the house **which** E then occupies.

In these circumstances, one **would not** expect a POA charge. There is no inheritance tax scheme since the **property** is part of E's estate and the borrowing is **not** internal. One **would** argue **that** E's estate still includes the house and therefore protection is available under **para 11 (1**). The difficulty is **that** on one view the loan is an excluded liability within **para 11**(7) reducing E's estate, albeit it is a loan on commercial terms with a bank.

We **would** argue **that** the relevant **property** for the purposes of **para 11** is simply the **value** of the **property** net of the commercial borrowing. As this is part of E's estate there is no POA charge.

Question 13

Is the above analysis correct?

HMRC answer to question 13

We agree with your analysis in paragraph 2.6.

2.6 In **those** home loan schemes where HMRC consider **that** there is a reservation of benefit in the debt, it **would appear that** the taxpayer can still face a POA charge – because **he** has made a disposal of land **which** is subject to an excluded liability. The fact **that he** has reserved a benefit in the debt does **not** make the debt part of his estate such **that** the excluded liability can be ignored.

Question 14

Where there is a reservation of benefit in respect of the loan can HMRC confirm **that** they **would not** expect the taxpayer to pay both POA and IHT and **that** the inheritance tax charge **would** take priority?

HMRC answer to question 14

We agree with the analysis at 2.6. (Even if there is a reservation of benefit in the loan for IHT purposes, it is the land, **not** the loan, **which** is the relevant **property** for POA purposes and **para 11**, Sch 15 in particular. And although the loan may be **property** subject to a reservation for IHT purposes, it remains an excluded liability within **paras 11**(6) and (7), Sch 15 for the purposes of the POA charge.) As matters currently stand, there is no provision to disapply the charge **that** may arise under Sch 15.

Question 15

Will any statement be issued by HMRC as to **which** home loan schemes of the various types seen they consider do **not** work for inheritance tax purposes?

Otherwise taxpayers may self-assess and pay the income tax charge, thinking to preserve the inheritance tax savings but be unaware of HMRC's view.

HMRC answer to question 15

We will shortly be issuing updated technical guidance **that** will include material to identify the circumstances in **which** we consider a reservation of benefit in the loan exists. Hopefully, this will give some indication to providers of schemes affected whether or **not** we consider their scheme to be one where a reservation of benefit in the loan exists. This in turn may make it easier for providers to help any clients (or ex-clients) who seek their assistance over completion of their tax return.

3. **The effect of the Election**

3.**1** In the case of a married couple who have sold their jointly owned house to the **property** trust and given the debt to a second trust, it is assumed **that** one of them can elect to come within the gift with reservation rules and one can choose **not** to elect: i.e. it is **not** necessary for both to make the election.

Question 16

Will HMRC please confirm this point?

HMRC answer to question 16

As far as we can see, it is possible for one spouse and **not** the other to elect under paragraph 21.

3.2 There is some uncertainty about the effect of the election because **para** 21 does **not** as such deem there to be a gift for inheritance tax purposes but simply states **that** the **property** is treated as **property** subject to a reservation.

Furthermore in **para** 21(2)(b)(ii) it is stated **that** only sections 102(3) and (4) are to apply and **not** specifically section 102(8) **which** brings in Schedule 20.

We assume **that** the wording in **para** 21(2)(b)(i) referring to the **property** being treated as **property** subject to a reservation of benefit for the purposes of the 1986 Act does **not** limit the scope of the reservation of benefit provisions so **that** only sections 102(3) and (4) apply.

Example 5

D effected a home loan scheme. **He** elects into reservation of benefit and then in April 2010 starts to pay full consideration for the use of his house. Has **he** made a deemed PET at **that** point (under s102(4)) and is **he protected** from a reservation of benefit charge provided **he**

continues to pay a market rent? We assume **that** HMRC take the view **that para** 21(2)(b)(ii) does **not** narrow the effect of 21(2)(b)(i) and the let-outs in **para** 6 Schedule 20 apply.

Question 17

Please confirm **that** on making an election there is a reservation of benefit in the house and **not** the debt in respect of the home loan scheme and **that**, once an election is made, all the provisions relating to reservation of benefit in FA 1986 and in particular Schedule 20 apply?

Please also confirm the position on deemed PETs in the example above where the person who elects is already paying full consideration.

Suppose A elects into GWR in respect of his home. The house is then appointed back to **him** absolutely (i.e. the arrangement eg. a home loan scheme, is unscrambled). In these circumstances the reservation of benefit has ceased but the house is back in their estates anyway. Is there a deemed PET under section 102(4) FA 1986?

HMRC answer to question 17

We confirm **that** on making an election under paragraph 21, there **would** be a reservation of benefit in the house, **not** the debt in respect of the home loan scheme. In our view, the reference to section 102(4) Finance Act 1986 in paragraph 21(2)(b)(ii) envisages circumstances in **which** the **property** ceases to be subject to a reservation and there is nothing to suggest **that** these **would not** include circumstances in **which** the provisions of paragraph 6, Schedule 20 Finance Act 1986 **would** be in point.

By analogy with the view we have taken for "actual" gifts with reservation, we believe **that** the tax treatment for the purposes of Sch 15 **would** depend on whether or **not** the taxpayer starts to pay full consideration for the continued use of the house or chattel immediately on making an election or after a period of time. We think it **would** only be in the latter case **that** there **would** be a deemed PET under section 102(4) FA 1986.

In our view, the provisions of s 102(4) do, in terms, apply, by virtue of **para** 21(2)(b)(ii), when the taxable **property** is appointed back to the chargeable person. But the **value** of A's estate **would not** be decreased by this deemed PET. On **that** basis we do **not** regard the deemed PET by A has having any practical consequences for A, because it **would** have no **value**.

3.3 We seek clarification of the position on home loan schemes when both spouses elect and one then dies.

Example 6

H and W have effected a home loan scheme. They both elect. On H's death his **share** in the house is worth £400,000 but is perhaps entirely subject to debt. His **share** passes to W but the **value** of her estate is **not** increased because H's **share** is subject to the debt. Hence the concern is **that** the effect of the election is to make H's **share** taxable immediately on his death by virtue of s 102(3) as to £400,000.

In our view it **would appear that** the spouse exemption is available on the first death since the deceased's **share** in the house passes to the surviving spouse under the terms of the **property** trust or otherwise becomes comprised in the survivor's estate as IHTA 1984 requires. This is so even if the **value** of the debt equals or exceeds **that** of the house.

Question 18

(a) Do HMRC agree with this interpretation? (See also Statement of Practice E13.)

(b) Is HMRC's view **that**:

—full spouse exemption is available even if the debt equals the **value** of the house; or

—full spouse exemption is available provided the spouse's estate is increased by even a small amount; or

—spouse exemption is only available to the extent the **value** of the house exceeds the debt?

HMRC answer to question 18

In the circumstances outlined in Example 6, the starting point is the disposals of **property that** H & W have each made in order to effect a home loan scheme. If then they elect under paragraph 21 and H then dies, we think the effect **would** indeed be to bring £400,000 into H's estate immediately before his death for IHT purposes by virtue of section 102(3) Finance Act 1986. As far as we can see, there is no scope for spouse exemption as regards this chargeable item as the **property** disposed of by H in setting up the home loan scheme did **not** become comprised in the estate of W. Nor, having regard to paragraph 21(3) can we see any scope for

reducing the amount charged under section 102(3) FA 1986 by the amount of the debt. Of course, H's estate for IHT purposes will also include his interest in possession in the property trust. We imagine this would consist of his share in the house, subject to the debt. Undoubtedly spouse exemption would be available, but only to the extent that the value of H's share in the house exceeded the debt.

3.4 As noted in 1.5 above there are technical difficulties if the property is sold after an election. Assume that a smaller replacement property is acquired by the trustees but the debt is not repaid. Accepting that the replacement property will be within the para 3 land charge, what of the surplus cash which has been invested in intangibles?

Example 7

Suppose the taxpayer moves out of the home and has made an election. He purchases a smaller replacement house a week later. The balance of the proceeds are invested and he enjoys the income as life tenant.

Question 19

Does a new election need to be made at that point under para 22 in relation to the intangibles part and/or under para 21 in relation to the smaller home?

What happens if the time limits for making the election on the original property have passed?

HMRC answer to question 19

Para 21(2)(a) states that when an election has been made the income tax charge won't apply to the taxpayer's enjoyment of the relevant property "or of any property which has been substituted for the relevant property". From the "any property" we take that to include not only property in the form of land and chattels but also intangible property even though that is subject to a separate paragraph for the election. The equivalent measure in Para 22(2)(a) uses the phrase "or any property which represents or is derived from the relevant property". We think this difference is necessary as it may not be possible to "substitute" intangible property for other intangible property.

But we assume you can convert intangible property into something different and we think an election under Para 22 would similarly cover cases where intangible property is converted into land or chattels and would otherwise be subject to an election under Para 21. So as the paragraphs cover substitutions/derivations, we do not think we require a fresh election when the underlying property changes. In any event, if the taxpayer apparently has an interest in possession in the intangible property, would not paragraph 11(1) be in point assuming a home loan scheme was not involved? As we would not be looking for a fresh election, we assume part (b) of the question is not relevant.

3.5 It may be said that the deeming provision in section 660A(1) TA 1988 (now s 624 ITTOIA 2005) is irrelevant to interest in possession trusts where the settlor is life tenant given that there is no question of the income being taxed as that of any other person as envisaged in that provision.

Question 20

Does the para 8 charge apply to cash held in such a trust on the basis that this is a settlor interested trust to which section 660A TA 1988 (now s 624 ITTOIA 2005) is therefore applicable or does the fact that the settlor is the life tenant of this trust preclude the application of section 660A? This would obviously affect the election mechanism. This is relevant to home loan trusts now holding intangibles.

HMRC answer to question 20

We are not sure that we can see how the application of section 624 ITTOIA 2005, and therefore paragraph 8 is explicitly precluded per se.

3.6 **Question 21**

When an election is made on a double trust scheme, is this election in respect of the entire land or just the part subject to the debt? Can HMRC confirm the former is correct given that in para 21(3) the DV/V formulation would mean that the entire value of the land equals DV?

HMRC answer to question 21

It seems to us that the relevant property in terms of Schedule 15 generally and specifically for the purposes of the election would be the land in its entirety.

3.7 The election mechanism does not satisfactorily deal with the position where part of the original gifted property is not within the Regime and part is.

Example 8

Andrew gives his house on interest in possession trusts for spouse Emma in 2000. Her interest in possession is terminated in all but 20% of the fund. Hence the gift ceases to be an excluded disposal in relation to 80%.

Andrew decides to make an election rather than to pay the income tax charge. In these circumstances is the chargeable proportion 100% (being the DV/V figure) or 80%?

It is assumed the latter on the basis **that** Andrew is chargeable only by reference to his enjoyment of the 80% **not** by reference to his enjoyment of 100% (see wording in **para** 21(**1**)(a)). Hence "the relevant **property**" on **which he** can elect is only 80%.

Question 22

Do HMRC agree with this analysis?

HMRC answer to question 22

We **would** agree **that**, in the circumstances set out in Example 8, the "relevant **property**" **would** be 80% of it. The use of the formula DV/V, as ordained in paragraph 21(3), **would** simply mean **that** all of the 80% **would** be treated as the chargeable proportion.

3.8 Where a taxpayer is doubtful as to whether **he** is caught by the Regime in the first place **he** can put full details of his arguments on the additional information pages of the return and presumably **would** then be treated as having made full disclosure and be **protected** from a discovery assessment. Of course, even if a taxpayer does obtain finality in one tax year, this will **not** prevent HMRC raising an enquiry in later years if the taxpayer continued to self assess on the basis **that** the Regime does **not** apply to **him**.

Suppose HMRC do **not** enquire into the taxpayer's return for 2005/6. In 2006/7 **he** continues to self assess on the basis **that he** is outside the Regime; HMRC make an enquiry and it is established **that** the taxpayer was wrong to self assess on the basis **that** no income tax was due under the Regime. Possibly a court case clarifies the position or there is a change in legislation **which** is deemed to have always had effect.

In these circumstances the taxpayer will have missed the deadline for making the election (**he** first became chargeable under the Regime in 2005 and therefore needed to elect by January 31, 2007) and will have to pay income tax going forward or else try to unravel the arrangement.

Question 23

Will the taxpayer be able to make a late election in these circumstances?

HMRC answer to question 23

Whether the taxpayer is **protected** from a discovery assessment in the circumstances described will depend on whether the argument **he** presents is tenable and if **not** whether **he** could then be considered negligent in submitting an insufficient self assessment. Tenability **would** need to be judged against the practice generally prevailing at the time the return was made. We **would** consider **that** the taxpayer was bound by the time limit for **that** year of assessment for making an election regardless of whether HMRC made an enquiry relating to **that** year or a later year. It **would** be for the taxpayer to demonstrate **that he** had a reasonable excuse for failing to make an election in time.

In a situation where a court decision overturns the previous practice or legislation makes changes **which** is deemed to have always had effect, then the taxpayer **would** be **protected** for earlier years and **he would** be chargeable only from the time the change in practice or legislation was made. It **would not** be unreasonable to assume **he would** then have until the deadline for **that** year of assessment to make an election.

3.9 Another difficulty arises if the taxpayer wrongly pays income tax on the basis **that he** was within the Regime when in fact **he** was **not**. This is particularly pertinent in relation to home loan schemes where HMRC **appear** to accept **that** some work and some do **not**.

Question 24

What position will be taken by HMRC in these circumstances? Will the taxpayer (or his personal representatives) be able to make a claim for repayment of the tax paid under a mistake of law for 6 years from the date of overpayment?

HMRC answer to question 24

Providers of certain home loan or double trust schemes are already aware **that** HMRC takes the view **that** the gifts with reservation of benefit legislation applies to them. We will include in our

guidance information about the circumstances in **which** we consider the GWR legislation applies.

If the taxpayer has made an excessive self assessment by virtue of error or mistake in his return then **he** can claim relief under section 33 of the Taxes Management Act 1970. The time limit for doing so is 5 years from the 31 January following the year of assessment to **which** the erroneous return relates.

4. **Regulation 5 and para 10(1)(a) – Equity Release Schemes**

4.1 The relief given in Regulation 5 seems unnecessarily restrictive as a matter of principle and we do **not** fully understand the Ministerial Statement or the Guidance Notes on this. It is suggested **that** where a child moves into the house to care for an aged parent and acquires an equitable interest in the **shared** home in consideration for providing caring services, the parent is **protected** from a POA charge under Regulation 5(b). However, such a disposal does **not** seem to be by way of a *transaction* at *arm's length* between persons **not** connected with each other. These are **not** normal commercial arrangements. It is difficult to put a **value** in advance or even retrospectively on what the services to be provided will actually be worth in terms of a **share** in the house.

Question 25

What evidence is required to satisfy Regulation 5(b)? It will be difficult to establish what **would** be regarded as an arms length transaction without a court hearing **which would** generally only occur in the event of a dispute.

HMRC answer to question 25

In considering whether regulation 5(b) was satisfied, we **would** need information about how the essential elements of the transaction had been arrived at. We do recognise **that** there is a substantial body of case law dealing with the circumstances in **which** an interest in a house is acquired in consequence of a person acting to his detriment. The Ministerial Statement had these sorts of situations in mind and we **would** interpret Regulation 5 accordingly. In particular, we accept **that** the requirement **that** "the disposal was by a transaction such as might be expected to be made at arm's length between persons **not** connected with each other" **would** be interpreted with such cases in mind. We **would not** therefore expect the parties to have sought separate advice and acted upon it or to have obtained a court order confirming the **property** entitlement. We recognise **that** detriment **that** the acquirer can demonstrate **he** has suffered can provide consideration for the acquisition of the interest and prevent the transaction from being gratuitous.

4.2 Suppose **that** something **that** had **not** been a readily convertible asset and was therefore **protected** under **para** 5(**1**)(b) subsequently became a RCA under ITEPA. We are concerned **that** a transaction **that** was previously **protected** could now lose such protection.

Question 26

What happens if the definition of readily convertible asset in ITEPA 2003 changes?

HMRC answer to question 26

If the definition of "readily convertible asset" in ITEPA 2003 were to change, I think we **would** need to review the appropriateness of Regulation 5(2). We are **not** aware **that** any such alteration is in prospect, however.

4.3 There are difficulties where land is held under one title but is physically discrete — for example, two fields. Suppose father sells one of the two fields to his son for full **value** and continues to farm in partnership over **that** field. Does father have a pre-owned assets problem.

Question 27

Is the father **protected** under **para** 10(**1**)(a)? Can it be treated as a sale of whole if son becomes beneficially and legally entitled to the entire field even though father is selling only one of the fields?

HMRC answer to question 27

The first issue is what constitutes "the **property**" for the purposes of paragraph 10(**1**)(a). We think it **would** be possible to regard each of the two discrete fields as "the **property**", so the disposal of one of them **would** be a disposal of the whole interest in **that** asset. As far as your example is concerned, a sale by father to son **would** be within paragraph 10(**1**)(a)(ii) on the basis **that** father receives a full open market price for his land.

4.4 It is **not** uncommon for taxpayers to enter into transactions whereby they carve out a lease for **themselves** and sell the freehold reversion at full market **value**. Indeed some commercial equity release schemes are structured along these lines. In earlier informal discussions HMRC **appeared** to agree **that** the wording in **para** 10(**1**)(a) did cover such arrangements but the Guidance Notes suggest there has to be a disposal of the taxpayer's entire interest without any reservation of a lease. The provisions on non-exempt sales of course use a different wording.

Question 28

Can HMRC confirm **that** a disposal of a taxpayer's whole interest in the **property** "except for any right expressly reserved by **him** over the **property**" as set out in **para** 10(**1**)(a) is intended to cover a transaction where F has carved out a lease for himself and sold the encumbered freehold reversion for full market **value** to his son? If so, will the Guidance Notes be amended to confirm this?

HMRC answer to question 28

In our view, paragraph 10(**1**)(a) does cover the scenario you envisage in 4.4. We will amend the Guidance Notes.

5. **Reversionary lease arrangements**

5.**1** In the case of reversionary lease arrangements, the taxpayer retains the freehold interest giving away a long lease **which** vests in possession in (say) 20 years time. Assuming **that he** is within **para** 3 ie **that** the arrangement does **not** involve a reservation of benefit, the taxpayer may wish to pay a full rent for his use of the land so as to avoid a POA charge: see Schedule 15 **para** 4 (**1**). The difficulty is **that** the owner of the relevant land in this case **appears** to be himself and **he** cannot pay rent to himself.

Question 29

Does this mean **that** in the context of reversionary leases this part of the legislation is meaningless? To obtain relief under **para** 4, will the taxpayer have to transfer his freehold to an interest in possession trust for himself and pay rent to the trustees?

HMRC answer to question 29

We agree **that** it **would** be difficult for the taxpayer to pay rent to himself in order to avoid a charge under Schedule 15. But, as you suggest, it **would** be possible to overcome the difficulty.

5.2 The Guidance Notes state **that** reversionary lease arrangements effected post 8 March 1999 are **not** caught because they are subject to a reservation of benefit. You will be aware **that** many advisers do **not** agree with this view. On the basis of HMRC's current advice there is no requirement for a taxpayer to self assess and pay the pre-owned asset income tax charge. If, however, it turns out **that** HMRC are wrong in their view **that** post 8 March 1999 reversionary lease schemes are caught by the reservation of benefit rules, pre-owned assets income tax **would** have been due.

Question 30

If HMRC's views are successfully challenged in the courts will the taxpayer be subject to back tax, interest and penalties?

We **would** hope **that** HMRC **would not** in these circumstances seek to collect income tax (and interest) in respect of past years but only in respect of future years.

Will it be a requirement for all taxpayers who have done a reversionary lease scheme post March 1999 to put this on their tax return in the white space and explain why they are **not** paying income tax?

HMRC answer to question 30

Our view on the IHT treatment of reversionary leases and, in particular, the application of section 102A Finance Act 1986 to them is under review at the moment. We will be issuing guidance as soon as we can.

6. **Miscellaneous problems**

6.**1** There are difficulties in determining whether both contribution and disposal conditions have been met in a single transaction and this can be relevant when applying the exclusions in **para** 10 and the exemptions in **para 11**.

Para 3(2) provides **that** the disposal condition is met if the chargeable person owned an interest in the relevant land or "*in other **property** the proceeds of the disposal of **which** were directly or indirectly applied by another person towards the acquisition of an interest in the relevant land*."

Para 3(3) refers to the contribution condition being met where the chargeable person "*has directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of an interest in the relevant land or an interest in any other* ***property*** *the proceeds of the disposal of* ***which*** *were directly or indirectly applied by another person towards the acquisition of an interest in the relevant land*."

Question 31

Is the correct analysis of the interaction between the disposal condition and the contribution condition as follows?

1. If the transferred **property** is itself the relevant land (i.e. is occupied by the donor) only the disposal condition is met.

2. If the transferred **property** is cash and **that** cash is used by the donee to buy the relevant land occupied by the donor, only the contribution condition is met. If HMRC agree with this can the Guidance Notes be amended at **1**.2.**1** **which** suggest (we think wrongly) **that** the disposal **not** the contribution condition is breached if cash is given to the donee who then purchases a **property** for occupation by the donor.

3. If the transferred **property** is an asset other than cash, and the donee then sells **that** asset and uses the proceeds to buy the relevant land, both the disposal and the contribution conditions are met.

4. In such a case Sch 15 **para 11**(9)(a)(ii) means the relevant land is the relevant **property** for the purposes of **para 11**, so **that** the **para 11** exemptions can apply if the other conditions in **para 11** are met.

HMRC answer to question 31

Taking your four questions in turn:

If the **property** disposed of by the chargeable person is the relevant land, we agree **that** only the disposal condition in paragraph 3(2) is in point.

If the chargeable person transfers cash, **which** is then used by the donee to acquire relevant land, we agree **that** it is the contribution condition in paragraph 3(3) **that** is in point, **not** the disposal condition. As you suggest, our guidance at paragraph **1**.2.**1** needs revising on this point.

We agree **that** the contribution condition contemplates circumstances in **which** a chargeable person has indirectly provided consideration by way of a disposal of assets other than cash. Such a disposal might also meet the disposal condition, as you suggest.

Paragraph 3 makes it clear **that**, for the purposes of either the disposal or the contribution conditions, the "relevant land" is the land occupied by the chargeable person. In a case where the contribution condition (paragraphs 3(3) or 6(3), as appropriate) is in point, the "relevant **property**" for the purposes of the exemptions in paragraph **11** is the "**property** representing the consideration directly or indirectly provided": We think this must mean provided by the chargeable person. Whether this is the "relevant land must, we think, depend on whether paragraph 3(3)(a) or 3(3)(b) apply.

6.2 The meaning of the "provision" of "consideration" in the context of the contribution condition needs to be clarified. On the basis of the case law the word provided suggests some element of bounty.

On this basis our view is **that** if there is a transfer of Whiteacre by A (or another asset) to his son at full market **value which** is then sold by son and the sale proceeds used to purchase Blackacre for A to occupy this is a breach of the disposal but **not** the contribution condition because it lacks the necessary element of bounty.

Similarly the provision of a loan on commercial terms by A to his son to enable son to purchase a house **which** A then occupies in our view does **not** fall within the contribution condition.

Question 32

Do HMRC agree with this analysis?

HMRC answer to question 32

In our view, it is arguable **that** the contribution condition does **not** depend on a degree of bounty for its application. If, on the contrary, a degree of bounty was necessary, might **not** the operation of the contribution condition provisions in paragraphs 3(3) and 6(3) of Schedule 15 be circumvented by the relatively simple expedient of A, in your example, providing the wherewithal

for the purchase of a house by his son by way of a loan, ostensibly on commercial terms, **which** is then left outstanding indefinitely?

Having said **that**, we have considered further the sort of case where a loan is made **and operated** on commercial terms eg a commercial rate of interest is specified and paid and there are provisions for repayment of the loan over the sort of period one **would** expect to find in a truly commercial loan. Having regard to paragraphs 4(2)(c) or 7(2)(c) of Schedule 15, the chargeable amount **would** depend on the **value** of DV in R (or N) × DV/V: **that**'s to say on "such part of the **value** of the land/chattel as can reasonably be attributed to the consideration provided by the chargeable person." In the case where the loan is on truly commercial terms and conducted in a truly commercial way, we **would** accept **that** the attributable amount is nil or de minimis.

In determining "reasonable attribution" for the purposes of **para**. 4(2)(c), it is the terms on **which** the loan is made and operated **that** are relevant, as indicated above. In **that** context, the period over **which** the loan is repaid as well as whether a commercial rate of interest is charged is relevant.

Thus, where an interest-free loan is repaid over a typical "commercial" period, it **would** be reasonable to regard the interest foregone as attributable to the consideration provided by the chargeable person. In cases where the principal of the loan was left outstanding indefinitely, such principal could reasonably be regarded as attributable to the consideration provided.

[Following further CIOT representations to HMRC this HMRC response is now accepted to be wrong – see guidance notes issued on 30 May and **para 1**.2.**1** "HMRC do **not** regard the contribution condition set out in Schedule 15 **para** 3(3) as being met where a lender resides in **property** purchased by another with money loaned to **him** by the lender. Our view is **that** since the outstanding debt will form part of his estate for IHT purposes it **would not** be reasonable to consider **that** the loan falls within the contribution condition even where the loan was interest free."]

6.3 Clarification is requested on the position where a house is owned by a company but the company is funded by way of loan. The concern is over **paras 11(1**)(b) and **11**(3)(b).

Example 9

B owns 100 £**1 shares** in X Limited and otherwise funds it by shareholder loan. (Or the house is owned by a company held within an interest in possession trust for B and again the funding for the purchase comes by way of loan from trustees to company.) X Limited buys the house in **which** B lives. B *prima facie* falls within the **para** 3 charge. It **would appear that para 11(1**) **protects him**. The **shares** are **not themselves property which derive much value** from the house because they are worth substantially less than the house (see **para 11(1**)(b)(ii)) but the **shares** and the loan together are comprised in B's estate and between them indirectly **derive** their **value** from the house. On **that** basis **para 11(1**) does offer full protection.

Question 33

Do HMRC agree with this analysis or do they consider **that** the loan **derives** its **value** from the contractual undertakings **that** oblige the borrowing company to repay?

It **would** be odd if there is a POA problem when the company is funded by way of loan but **not** if it is funded by way of **share** capital.

HMRC answer to question 33

In our view, the loan, albeit an asset of B's estate, is **not property that derives** its **value** from the relevant **property**. However, our response to Q32 above **would** no doubt be applicable here in appropriate circumstances.

6.4 How is the charge computed under **para** 9 when the settled **property** comprises say a deposit account but also an overdrawn current account at 6 April in the relevant year? Is the POA tax charge based simply on the **value** of the deposit account without deducting the overdraft?

The definition of relevant **property** is **property which** is or represents **property which** the chargeable person settled. If A settles cash into trust retaining a remainder interest and then the trust invests **that** cash unwisely e.g. in a hedge fund incurring losses **which** require the trustees to borrow to settle, is it the net or gross **value** of the trust fund **that** is taken in computing the POA charge?

Question 34

Can HMRC clarify the above?

HMRC answer to question 34

In our view, it is the net **value** of the trust fund as at 6 April in the relevant year **that** should form the basis of the computation under paragraph 9.

6.5 The excluded transaction provision in **para** 10(2)(c) refers to an outright gift "to the other person" whereas the wording in **para** 10(2)(e) refers expressly to an outright gift to an individual. The word person must include trusts and companies. In our view **para** 10(2)(c) applies to settled gifts *and* gifts to individuals although of course cash gifts *into trust* will be caught by the tracing rules in schedule 20 and are therefore generally gifts with reservation if the donor can benefit from the trust and **protected** anyway under **para 11**(3).

Question 35

Do HMRC agree with this analysis?

HMRC answer to question 35

We think the "other person" referred to in paragraph 10(2)(c) must be the person referred to in paragraphs 3(3) and 6(3) as acquiring an interest in the relevant land etc. We agree **that** such a person need **not** necessarily be an individual. But we are more doubtful **that** an "outright" gift of money could include a gift to be held on trusts.

6.6 Partnership issues

The Guidance Notes suggest **that** a partnership is transparent for inheritance tax purposes. While this is true for capital gains tax purposes, as a matter of law a gift of a partnership interest is **not** a gift of the underlying assets within the partnership.

We therefore do **not** understand the example given in Appendix **1 which** refers to C who gives his son D an interest in the partnership in return for D taking on the day to day running. In these circumstances why is there a disposal of land or chattels at all? There is a fundamental distinction between a firm's capital on the one hand and its individual assets on the other. C's proportionate interest in the capital may be equal to the **value** of the land or chattels but it is **not** an interest in the land or chattels itself and therefore **he** cannot dispose of **that** land (or the chattels) when **he** makes the gift of the partnership interest. See *Lindley on Partnerships* 17th Edn.

Question 36

Are HMRC treating partnerships as transparent for POA income tax purposes?

HMRC answer to question 36

We do **not** intend to treat partnerships as transparent for the purposes of Schedule 15. We will amend the example in Appendix **1** of the Guidance **that** you refer to.

6.7 Certain questions arise in relation to the annual exemption.

Example 10

X carried out a home loan scheme. In June 2005 **he** dismantles the scheme. The benefit enjoyed for POA purposes from April to June is £4,000.

Question 37

Will HMRC confirm **that**:

where the *de minimis* exemption under **para** 13 is **not** exceeded it is **not** possible for the transferor to make an election because **he** is **not** "chargeable to income tax"?

the £5,000 exemption is **not** pro-rated when a taxpayer is chargeable for only part of the year?

HMRC answer to question 37

We confirm both (a) and (b) are correct.

6.8 In a number of circumstances it is possible for (say) the husband to be caught by POA charge because **he** has made a disposal but **not** a gift and the wife to be caught potentially by gift with reservation.

In these circumstances do they each have to pay full consideration to escape their respective charges?

Example 11

In 1998 H transfers some **properties** into a company **he** wholly owns in consideration of the issue of **shares**. **He** has breached the disposal condition. **He** gives the **shares** to his wife. In

2003 W gives the company **shares** to her sons and later both of them occupy one of the **properties** owned by the company. H and W are **not** directors of the company.

In these circumstances H might wish to pay rent under paragraph 4 and W might want to pay full consideration under **para** 6 Schedule 20 in order respectively to avoid a pre-owned assets tax charge and a reservation of benefit situation.

Question 38

Is it sufficient **that** they pay such rent under an assured shorthold tenancy from their joint account and are jointly and severally liable for the rent?

Or does each person have to pay the full consideration separately?

HMRC answer to question 38

It seems to us **that** Example **11** is dealing with concurrent charges under two separate regimes: Schedule 15, and section 102 Finance Act 1986. In our view, it is arguable **that** H and W each has to pay full consideration separately in order to meet the separate requirements of paragraph 4(**1**) Schedule 15 and paragraph 6 Schedule 20 Finance Act 1986.

6.9 In **1**.3.**1** of the Guidance Notes under the bullet points relating to the spouse having to take an interest in possession from the outset it is **not** clear whether, if the interest in possession of the spouse or former spouse has come to an end other than on their death, the transaction is **not** an excluded transaction from the outset or whether it becomes so from the time the interest in possession terminates. It must surely cease to be an excluded transaction only from the time the interest in possession terminates.

Question 39

Will HMRC please clarify this point and confirm **that** the transaction only ceases to be an excluded transaction from the date the spousal interest terminates and therefore it is only from **that** point onwards there is a POA charge. Furthermore **para** 10(3) states **that** a disposal is **not** an excluded transaction if the interest in possession of the spouse comes to an end otherwise than on death of the spouse. Suppose a spouse becomes beneficially entitled to the **property** absolutely e.g. if the trustees advance the **property** outright to her so she becomes absolutely entitled. In these circumstances does the excluded transaction protection end? Her interest in possession has ended but only because she has become absolutely entitled to the **property**.

HMRC answer to question 39

In view of the way in **which** paragraph 10(3) is drafted, it is clear **that** the transaction ceases to be an excluded transaction only from the time **that** the interest in possession comes to an end otherwise than on the death of the (former) spouse.

As far as **para** 10(3) is concerned, we can see how it might be said **that**, where a spouse becomes absolutely entitled, the protection afforded by **paras** 10(**1**)(c) or 10(2)(b) is no longer available, particularly as the **property** in question **would** no longer be settled **property**. **That would** be a less than satisfactory result in our view, particularly bearing in mind the related provisions in **paras** 10(**1**)(b) and (2)(a). A more satisfactory approach might be to regard the interest in possession, **which** is **not** limited in terms to settled **property** as far as the reference in **para** 10(3) is concerned, as **not** coming to an end in these circumstances.

6.10 4.6 of the Guidance Notes give some examples of what HMRC consider constitutes occupation and the helpful letter from Mr McNicol dated 22 April 2005 gives further explanation. However, we do **not** fully understand HMRC's comments in this area. Please could the following common scenarios be clarified so **that** the taxpayer can self-assess appropriately. This is particularly relevant in relation to holiday homes.

Question 40

If there is a right to use a **property** throughout the year but it is **not** in fact used by the chargeable person, is it correct **that** there is no POA charge?

If there is a right to use a **property** throughout the year and the chargeable person uses the **property** but it falls within the de minimis limits set out in the guidance notes, is it correct **that** there is no POA charge?

If there is a right to use a **property** throughout the year and the chargeable person uses the **property** for say 3 months of the year there is a POA charge based on the whole year, even though others may have the right to use the **property** during **that** period (we are thinking particularly here of holiday homes)?

If there is a right to or actual storage of items in the relevant **property** but the chargeable person never lives there and the **property** is occupied by someone else, is it correct **that** there is no occupation of land within schedule 15?

Would the position of HMRC differ in (d) above if the **property** remained empty?

HMRC answer to question 40

Before dealing with your individual questions, we think it is worth reminding you of our view **that** occupation and use should be construed widely and are **not** confined to physical occupation.

If there is a right to use, but no occupation or use (in the wider sense) by the chargeable person in the year, it is unlikely **that** there **would** be a Schedule 15 charge.

We are **not** sure we can confirm **that** no Schedule 15 charge **would** arise in these circumstances. The examples of *de minimis* use given in paragraph 4.6 of the Guidance Notes do **not** contemplate (or, at least, do **not** assume) a right to use in the hands of the chargeable person for the rest of the year. If there is a right to use the **property** with even a small amount of use, the issue of how in fact the **property** was used for the rest of the year **would** need to be considered and whether this use also constituted use by the chargeable person.

We **would** agree **that** a Schedule 15 charge based on the whole year **would** arise.

We think it is difficult to give an assurance **that** there is no occupation of land under Schedule 15 by the chargeable person, if **he** is actually storing assets in the **property**. Particularly if **he** might have a right of access to these items, the circumstances might suggest **that** both the chargeable person and the person living in the **property** were using it.

By saying **that** the **property** remains empty, we assume you are envisaging **that** no-one is living in it. On **that** basis, if the chargeable person is storing items there, it seems clear **that he** is using the **property** for the purposes of Schedule 15.

6.**11** The position on non-exempt sales is unclear. It is our view **that** there is no POA charge because the cash element paid is excluded under the computation in **para** 4 and the undervalue element is a reservation of benefit anyway and therefore exempted from POA under **para 11**(3).

If there is a part exchange at an undervalue with a cash adjustment, i.e. Y transfers Whiteacre worth £800,000 to X in exchange for Greenacre worth £200,000 and X also pays Y cash of £500,000, if at 6/4/05 Whiteacre is worth £800,000 (i.e. total consideration is paid by X of £700,000) we assume **that** POA is payable only on £200,000. The cash element is excluded under **para** 4 and the undervalue element is excluded under the reservation of benefit provisions.

Question 41

Is the above analysis correct?

HMRC answer to question 41

We broadly agree with this analysis. (We have assumed **that**, in order for this question to arise at all, Y continues to occupy Whiteacre after the transfer.)

In more detail, we **would** regard Y's disposition as one partly by way of gift (as to £100,000) and partly by way of sale (as to the remaining £700,000). In the circumstances envisaged, the proportion of the **value** of Whiteacre disposed of by way of gift **would** be treated as **property** subject to a reservation, thus remaining in Y's estate for IHT purposes and so, by virtue of paragraph **11**(3), disapplying paragraph 3 to **that** extent. And, again in the circumstances envisaged, the disposition by way of sale **would not** be an excluded transaction and thus **would** be a non-exempt sale for the purposes of paragraphs 4(2) and (4).

We then need to apply this analysis to the provisions of paragraph 4 **that** determine how the chargeable amount is to be calculated and, in particular the R × DV/V formula in paragraph 4(2). First, we assume **that**, in this example, the relevant land **would** consist of 7/8ths of Whiteacre and, for any taxable period, V, in paragraph 4(2), **would** be the **value** of 7/8ths of Whiteacre at the appropriate valuation date. Looking at DV, we agree **that**, in applying the formula at paragraph 4(4) to arrive at the "appropriate proportion", P **would** be limited to the cash element of the consideration. Thus, in your example, (MV – P)/MV **would** be (£700,000 – £500,000) / £700,000, or 2/7.

In order to calculate the chargeable amount for a taxable period, let us assume **that** at the valuation date 7/8 of Whiteacre is worth £875,000 (the whole being worth £**1**,000,000) and the rental **value** (R) is £38,500. The appropriate rental **value**, as prescribed in **para** 4(4) **would** therefore be £38,500 × (2/7 × £875,000) / £875,000: in other words, £**11**,000.

(More simply, the calculation is £38,500 × 2/7.)

7. **Foreign domiciliaries**

7.1 Paragraph 12(3) states that no regard is to be had to excluded property. In a case where a trust settled by a foreign domiciliary) owns a UK house through a foreign registered company the shares in the company (and any loan to the company) are excluded property. Concern has been expressed that since para 12(3) says that no regard is to be had to these assets, this in turn means that the shares and loan have to be ignored in applying para 11 and in particular cannot be taken into account in determining whether there is derived property which is in the taxpayer's estate or GWR property in relation to him (which the shares and loans otherwise are). We think that this argument is misconceived but it has been advanced.

Question 42

Can HMRC confirm that they agree para 12(3) does not operate in this way and that para 11 can still work to protect the UK house or underlying assets owned by the offshore company in these circumstances?

HMRC answer to question 42

We agree with what you say in paragraph 7.1 about the interaction between paragraphs 12(3) and 11.

8. **Scope of the para 8 charge**

8.1 In addition to the points raised on valuation, we note that on insurance schemes involving for example quantitative carve outs (for example where the settlor taxpayer is the remainderman in the settlement as in a reverter to settlor trust) the settlor is treated as being outside the POA charge. This is on the basis that his interest in the trust property is either held on bare trust or on a separate trust.

Question 43

Will HMRC confirm that reverter to settlor trusts holding other assets are also outside the para 8 charge?

HMRC answer to question 43

If you are suggesting that reverter to settlor trusts are outside the scope of sections 624 and 625 ITTOIA 2005, we would be interested to see the reasoning put forward in support of this proposition. In the insurance schemes you mention, which we have agreed do not fall within the said sections 624 and 625 and therefore are outside the scope of paragraph 8, the interests held on trust for the settlor are, as you suggest, carved out of the gift and retained by him. In our view, such schemes are not analogous with reverter to settlor trusts.

Question 44

There is a potential problem about the wording in para 22(3): if income is treated as income of the chargeable person by virtue of section 660A then due to paragraph 22(3)(b) it shall be treated as property subject to a reservation. Income could be taxed under s 660A (now s624 ITTOIA) if only a spouse could benefit and that would not normally bring para 8 into play in the first place although this exclusion is not carried forward once an election is made.

So if someone elects on intangibles and then he but not his wife is excluded from benefiting under the settlement does this mean that the conditions in para 22(3) are satisfied and hence that he is still treated as having a reservation of benefit? Or does paragraph 22(2)(b)(ii) (which says sections 102(3) and (4) shall apply) mean that if he ceases to reserve a benefit in the property himself the effect of the election falls away so that there is a deemed PET then, even if the conditions in para 22(3) are prima facie satisfied because his wife can still benefit?

HMRC answer to question 44

We lean towards your first interpretation of the effect of para 22(3)(b). If someone is in a position to make an election under para 22(2), he or she must be someone who is (or would be) chargeable under para 8 for that year of assessment. Clearly, the condition in para 22(3)(b) would also be met at that time. It does seem that this condition would continue to be met until such time that both the chargeable person and his or her spouse (or civil partner) were excluded from benefit. At that point, a PET would be deemed to have arisen by virtue of para 22(2)(b)(ii).