

## POAT: Death of “reverter to settlor” trusts?

1. The Finance Act 2004 s.84 and Sch.15 introduced an entirely new tax charge known as “the pre-owned assets” charge. It was made clear through the 2004 Finance Bill’s progress that the government was targeting “*contrived arrangements to dispose of valuable assets, while retaining the ability to use them*” (2004 Budget Press Release). In summary, POAT works like this.
  - Sch.15, s.84 imposes what is generally regarded as a tax on capital, levied as income tax, on individuals based on
    - (a) the benefit they enjoy from the occupation of land or possession or use of chattels which they once owned, or which they assisted other persons to acquire; and
    - (b) their deemed power to enjoy intangible property in certain settlor-interested settlements.
  - The charge is imposed under three main heads:
    - (1) land;
    - (2) chattels;
    - (3) intangible property.
  - In determining whether the charge arises in respect of land or chattels, certain transactions are “excluded” or “exempt”.
  - Chargeable amounts are determined by reference to detailed computational rules in the legislation.
  - Limited reliefs prevent double charges to tax.
  - Special rules apply to individuals not resident or not domiciled in the UK.
  - There is provision for opting-out with IHT consequences.
  - The income tax charge may be triggered by transactions that occurred or circumstances that prevailed at any time after 17.03.86, even though the legislation is effective for 2005-06 and subsequent years. This was addressed by the Joint Committee on Human Rights which decided that the legislation did not give rise to any significant risk of incompatibility with Art. 1 of the First Protocol

to the European Convention on Human Rights (protection of property). The government said this was not retrospective but retroactive legislation giving rise to an entirely new fear for tax advisors.

- The Revenue published its Technical Guidance on 16.03.05 which was revised by 06.04.05. Anyone intending to rely on this Guidance should refer to the latest version on the HMRC website.

2. Various definitions (some imported from IHTA 1984) are provided in paras.1, 2.

### **Paragraph 3: Land**

3. The charge to income tax arises where

“3 (1)

- (a) an individual occupies any land, whether alone or together with other persons, and
- (b) the disposal condition or contribution condition is met as respects the land.”

4. “Occupies” is not defined. It is expected to be confined to “actual physical occupation” and not to extend to unexercised rights to occupy land.

5. The creation of new interests in land by disposition is to be taken as a disposal of part of the existing interest (Sch.15, s.84, para.3(4)).

6. The disposal condition is that

“3 (2)

- (a) at any time after 17<sup>th</sup> March 1986 the chargeable person owned an interest (i) in the relevant land or (ii) 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, and
- (b) the chargeable person has disposed of all, or part of, his interest in the relevant land or the other property, otherwise than by an excluded transaction.”

7. The contribution condition is that

“3 (3) ...at any time after 17<sup>th</sup> March 1986 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

- (a) an interest in the relevant land or
- (b) 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.”

8. There is no requirement that “another person” is an individual. Thus, it could be a company or a trust. “Owned” is not defined although it is thought to refer to direct legal ownership (see, e.g. s.49 IHTA 1984).
9. The word “indirect” provides for the Revenue to carry out a tracing investigation. The replaced property may be any kind of property and includes routing the gift via a third party. There are no detailed rules specifying how the application of proceeds or the provision of a contribution is to be identified through intermediate transactions. There is one limitation: it is necessary to value such part of the relevant land or chattel “as can reasonably be attributed” to the property originally disposed of or consideration provided by the taxpayer. There are no rules determining how this value should be reasonable attributed. These are matters of fact and law. It remains to be seen how the Revenue will apply the concept of “reasonable attribution” and whether there will be some practical limits on tracing requirements (e.g. restriction of the number of intermediate transactions to be investigated or a limited timescale).
10. There is a *de minimis* exception where the aggregate of POAT for a year of assessment is less than £5,000.
11. Paras.4 and 5 sets out detailed computational rules for calculating the chargeable amount (see SI 2005/724, para.4 for the official rate of interest at valuation date. “Official rate” has the same meaning as s.181 Income Tax (Earnings and Pensions) Act 2003).

## Paragraph 6: Chattels

12. The charge is applied on broadly similar terms save that the charge on land depends on occupation whereas the charge on chattels depends on possession or use of the chattel:

“6 (1) This paragraph applies where-

- (a) an individual (“the chargeable person”) is in possession or, or has the use of, a chattel, whether alone or together with other persons, and
- (b) the disposal condition or the contribution condition is met as respects the chattel.”

13. “Possession” and “use” are not defined. The effect is likely to be very wide indeed with both being a question of fact (see, e.g. *Marvin v Wallace* (1856) 6 El & Bl 726). Nor is “money” defined although it is thought to include legal tender in any currency. This might encompass collections of money which are no longer legal tender.

14. The disposal and contribution conditions for chattels are set out in my handout.

“6 (2) The disposal condition is that –

- (a) at any time after 17<sup>th</sup> March 1986 the chargeable person had (whether alone or jointly with others) owned (i) the chattel, or (ii) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel, and
- (b) the chargeable person has disposed of all or part of his interest in the chattel or other property otherwise than by an excluded transaction.

(3) The contribution condition is that at any time after 17<sup>th</sup> March 1986 the chargeable person had directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of

- (a) the chattel or
- (b) any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of the chattel.”

15. “Provided” is not defined although it is used elsewhere in tax law (e.g. ITTOIA 2005, Pt 5, Ch.5, ss.619-648). The term has been held to connote some element of “bounty” and it is arguable that this should apply to POAT.
16. The *de minimis* exception referred to above applies. There is no *de minimis* provision to exclude chattels of small value although. This is likely to cause particular compliance problems because chattels are movable by nature and possession or use of small movable items may not always be easy to trace.
17. Again, detailed computational rules are provided for the calculation of the chargeable amount (paras.7 and SI 2005/724, para.4).

**Paragraph 8: Intangible property**

18. This charge applies on completely different terms where:

“8 (1)

- (a) the terms of a settlement, as they affect any property comprised in the settlement, are such that any income arising from the property would be treated by virtue of section 660A of the Taxes Act 1988 (income arising under settlement where settlor retains an interest) as income of a person (“the chargeable person”) who is for the purposes of Part 15 of that Act the settlor,
- (b) any such income would be so treated even if subsection (2) of that section did not include any reference to the spouse of the settlor, and
- (c) that property includes any property as respects which the condition in sub-paragraph (2) is met (“the relevant property”).

(2) The condition mentioned in sub-paragraph (1)(c) is that the property is intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17<sup>th</sup> March 1986.

(3) Where this paragraph applies in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under paragraph 9 is to be treated as income of the chargeable person chargeable to income tax.”

19. It is only necessary that the circumstances exist. There is no need for the taxpayer to benefit or for the property to produce actual income. Para.9 sets out the rules for calculating the charge arising on intangible property.

**Paragraph 10: Excluded transactions**

20. The concept of ‘excluded transactions’ only applies for the purposes of land and chattels. It has no application in relation to the POAT on intangible property. An excluded transaction may, however, involve any kind of property, including intangible property.

21. For the purposes of the disposal condition, the taxpayer’s disposal of any property is an “*excluded transaction*” if any of the following circumstances apply –

- it was a disposal of his whole interest in the property, except for any right expressly reserved by him over the property, by a transaction made (or as might expect to be made) at arm’s length with a person not connected with him (para.10(1)(a));
- the property was transferred to his spouse or (where the court orders) former spouse (para.10(1)(b));
- it was a disposal by gift (or court order for benefit of former spouse) by virtue of which the property became settled property in which his spouse or former spouse is beneficially entitled to an interest in possession (para.10(1)(c)). It is the Revenue’s view that the spouse must take an interest in possession from the outset. It is not an excluded transaction, however, if the interest in possession of the spouse or former spouse has come to an end other than on their death (Revenue’s Technical Guidance, Part 1.3.1);
- it was a disposition falling within the IHT exemption available for dispositions for maintenance of family (s.11 of IHTA 1984) (para.10(1)(d));
- it is an outright gift to an individual and is wholly exempt by virtue of either the IHT annual exemption or the IHT small gifts exemption (ss.19, 20 IHTA 1984) (para.10(1)(e)).

22. For the purposes of the contribution condition, the taxpayer's provision of consideration for another person's acquisition of any property is an "excluded transaction" if-
- the other person was his spouse (or former spouse by court order) (para.10(2)(a));
  - on its acquisition the property became settled property in which his spouse or former spouse is beneficially entitled to an interest in possession (para.10(2)(b)). Unlike in para.10(1)(d), there is no stipulation that the contribution must be a gift, or a transfer for the benefit of the former spouse in accordance with a court order; however, it should be borne in mind that it is arguable that the contribution condition may not apply where there is no element of bounty involved;
  - the provision of the consideration constituted an outright gift of money (in sterling or any other currency) by the taxpayer to the other person and was made at least seven years before the earliest date on which the taxpayer occupied the land or was in possession or had the use of the chattel (para.10(2)(c));
  - the provision of the consideration is a disposition falling within the IHT exemption for dispositions for maintenance of family (para.10(2)(d));
  - the provision of the consideration is an outright gift to an individual and is wholly exempt by virtue of either the IHT annual exemption or the IHT small gifts exemption (para.10(2)(e)).
23. For the purposes of POAT, "connected person" is defined as in s.839 TA 1988 but in an extended form: it includes uncle, aunt, nephew and niece. "Outright gift" is not defined and there seems nothing to prevent it from applying where the donee is a company or a body of trustees, though it is unclear whether a gift to trustees would qualify unless the donor was excluded from benefit under the trust.

### **Paragraph 11: Exemptions**

24. There are a number of exemptions which fall broadly into five categories –

- (1) property that is in the taxpayer's estate for IHT or whose value, so far as is attributable to the relevant property, is not substantially less than the value of the relevant property. "Substantially" is not defined although the Revenue's Technical Guidance has regard to the Revenue's interpretations of "substantial" as "more than 20%" in relation to CGT taper relief. Where the attributable value is substantially less than the relevant property, POAT is reduced by such proportion as is reasonable to take account of the inclusion of the property in the taxpayer's estate (para.11(2)). The aim of this restriction seems to be to defeat certain "home loan" schemes but the precise effect of the legislation is obscure. It is difficult to determine how the rules are to be applied and the Revenue's Technical Guidance does not assist;
- (2) property that is deemed to be in the taxpayer's estate under the gifts with reservation of benefit ("GWR") provisions. Again, there are provisions dealing with property deriving its value from the relevant property with the opportunity to proportionally reduce the POAT. It is particularly important to correctly identify whether or not the property in question (and any substituted property) is (or would be) subject to GWR rules;
- (3) property that escapes from the GWR provisions by virtue of certain specified IHT exemptions or reliefs. This encompasses the exemptions provided for by the GWR provisions, namely-
  - any of the exemptions in FA 1986, s.102(5)(d)-(i) which cover disposals by way of gift which are exempt for IHT purposes (i.e. gifts to charities, gifts to political parties, gifts to housing associations, gifts for national purposes etc. and employee trusts);
  - FA 1986, s.102B(4) (share of interest in land). The exemption from POAT extends not only to property within this IHT exemption, but also to property gifted before 9 March 1999 that would have fallen within this provision if gifted on or after that date. Following that date, donor and donee usually share household expenses *pro rata* to their ownership shares to ensure that the donor receives no benefit at the expense of the donee;

- FA 1986, s.102C(3) and Sch.20, para.6 (exclusion of benefit). The GWR provisions work for IHT on the basis that there can be no tracing through to replacement property following a gift of a sum of money in sterling or any other currency. However, in interpreting FA 2004, Sch.15, paras.11(5)(b)-(d) in a case where the contribution condition for land is met, exemption from POAT is available for any property which would have fallen within the GWR provisions but for this specific relief from tracing;
  - Full consideration exemption. This is of particular relevance to taxpayers who pay full consideration for occupation of land or possession of chattels to avoid the GWR rules. In the case of chattels, this exemption may be of particular importance where the chattels in question (e.g. works of art) are considered to command arm's length rents significantly lower than the interest rate that may be prescribed for calculating the POAT. NB. This exemption does not extend to 'use' of a chattel but only to 'possession' which suggests that there is no exemption available in respect of mere use falling short of actual possession;
- (4) property covered by certain equity release arrangements defined in the regulations. Concern was expressed that sales of a part share of property to commercial providers of equity release schemes would not qualify as an excluded transaction and an individual may be subject to the charge if they remained in occupation. This was recognised in the Regulations which specifically exempted disposals of part of an interest in any property by a transaction made at arm's length with an unconnected person: Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005 (SI 2005/724, reg.5). Furthermore, the exemption is extended to disposals of a part share to anyone provided that they were made on arm's length terms and either took place before 7 March 2005, or took place on or after that date for a consideration not in the form of money or assets readily convertible into money; and

- (5) certain *de minimis* amounts (para.13).

#### *Territorial issues*

25. FA 2004 Sch.15 does not apply in relation to any person for any year of assessment during which he is not resident in the UK (para.12(1)). There are circumstances in which a person may be resident for part of a year in which case the same rules will presumably apply for the purposes of POAT. Where a person is UK resident but not UK domiciled, Sch.15 does not apply unless the land, chattel or intangible property in respect of which the charge arises is situated in the UK (para.12(2)).

#### *Regulations*

26. Para.14 provides for further regulations conferring exemptions and para.20 for regulations under this Schedule generally.

#### *Valuations*

27. Except as otherwise provided, the value of any property shall for the purposes of Sch.15 be the price which the property might reasonably be expected to fetch if sold in the open market at that time (para.15).

#### *Post-death variations and disclaimers*

28. Dispositions by variation or disclaimer of an interest in the estate of a deceased person will not be regarded as a disposal or contribution that could give rise to POAT (para.16).

#### *Guarantees*

29. Guarantees in respect of loans are also disregarded (para.17).

#### *Reliefs in respect of double taxation*

30. Para.18 provides a measure of relief in respect of double taxation, e.g., a taxpayer might otherwise face a double charge on his occupation of land owned by a company and on intangible property comprising shares in that company. Under this

provision, the taxpayer will be liable for whichever charge produces the higher chargeable amount. The regulations include provisions to avoid a double charge to IHT in certain circumstances (SI 2005/724, reg.6).

31. Para.19 sets out the relationship with Part 3 of the Income Tax (Earnings and Pensions) Act 2003.

### **Opting-out**

32. Sch.15, paras. 21 (land and chattels) and 22 (intangible property) give the taxpayer the option of electing that any relevant property that would otherwise be subject to POAT to be treated as subject to the GWR provisions. If an election is made, the property will not be subject to the charge under POAT but will instead be subject to a charge to IHT on their death (unless the occupation or use ceases at least 7 years before death).
33. The election must be made on or before “the relevant filing date” (para.23). The election may be withdrawn or amended during the life of the chargeable person at any time *on or before* the relevant filing date. Where a person can show reasonable excuse for the failure to make the election on or before the relevant filing date, the election must be made on or before such later date as may be prescribed (para.23(4)). “Reasonable excuse” is not defined although the Revenue’s Technical Guidance suggests that an excuse is only reasonable if some event beyond the taxpayer’s control prevented him from sending the election in time (examples given include serious illness such as coma, heart attack, stroke, bereavement, fire or flood at the PO where the election was posted or prolonged industrial action by the PO – HMRC clearly do not anticipate agreeing that many excuses are in fact ‘reasonable’!).
34. The once-only decision whether or not to opt out will depend on a variety of factors, including the financial position and life expectancy of the taxpayer. The options are:

- Do nothing. In each case the POAT liability should be weighed against the IHT saving should the planning be successful.
- The charge will not apply if rent is paid in respect of the occupation or the land or the use of the chattel of an amount which is at least equal to the chargeable amount applicable under paras.4 or 7. This is unlikely to be an attractive option although there may be an overall saving to tax depending on the relative marginal rates of the chargeable person and the recipient of the rent.
- Unwind the arrangements. The steps involved and the tax consequences (including IHT, CGT and in some cases SDLT) will need careful consideration in relation to each scheme. The client may be in a position to make an outright gift of the property and either (unusually) cease occupying it or commence payment of a market rent. Alternatively, attempts could be made to restore the entire interest to the donor although this may not be practicable. CGT problems with unwinding *Ingram* or reversionary lease arrangements may be exacerbated by the combination of interests with low base costs which have appreciated in value and do not benefit from principal private residence relief.
- Make an election under paras.21-23. This involves conceding the effectiveness of the scheme (except possibly for double trust schemes). An election is irrevocable once the “relevant filing date” has passed.

35. It should be noted that payment of POAT under self-assessment will not provide any guarantee that HMRC will accept that the property in question falls out of the taxpayer’s estate for IHT on death. That will have to be judged on its merits at the time. Presumably, if IHT did become payable and income tax had been mistakenly paid, the latter would be repayable to the estate, subject to the six-year limit.

**Finance (No.2) Bill 2006, Clause 80: Restriction of exemption from charge to income tax**

36. POAT does not apply where the asset in question still counts as part of the taxpayer's estate for IHT purposes (Sch.15, para.11(1) or (5)). This interacts with an existing IHT exemption for property held on trust which reverts to the settlor when a beneficiary's interest terminates (or, in some circumstances, where it reverts to the spouse or civil partner or the widow, widower or surviving civil partner of the settlor) (ss.53, 54 IHTA 1984).
37. In particular, s.54(1) IHTA 1984 provides that, when a person who is beneficially entitled to an interest in possession in settled property dies while the settlor is still living, and the property reverts to the settlor, its value is left out of account in determining the value of the person's estate. Section 54(2) provides that the value is also left out of account if the living spouse of the settlor (or, after 5 December 2005, their civil partner) becomes beneficially entitled to the settled property; or if the settlor's UK-domiciled widow or widower or surviving civil partner becomes beneficially entitled to it where the settlor has died less than two years earlier. Ss.53(3) and 53(4) provide that the same exemptions apply where the interest in possession comes to an end during the life of the person beneficially entitled to it.
38. The Government is aware of schemes that are exploiting these exemptions to side-step both IHT and POAT. In a not unexpected move, Finance (No.2) Bill, clause 80 proposes to introduce legislation to prevent avoidance of POAT through the use of "reverter to settlor" trusts. Subsection 2(b) inserts new sub-para.(11)-(13) into para.11 of Sch.15. . New sub-para.(11) provides that new sub-para.(12) applies where:
- the relevant property has ceased to be comprised in a person's estate for IHT purposes, or
  - the person has directly or indirectly provided any consideration for the acquisition of the relevant property

and the relevant property or any derived property is subsequently comprised in the person's estate for IHT purposes by virtue of their being beneficially entitled to an interest in possession in it.

39. New sub-para.(12)(a) provides that, in those circumstances, the relevant property and any derived property are not to be treated as being comprised in the taxpayer's IHT estate for the purposes of para.11(1) and (2). The effect is that the exemption from POAT in para.11(1) and the reduction in para.11(2) to the appropriate rental value, the appropriate amount or the chargeable amount, will not apply.
40. New sub-para.12(b) provides that the relevant property and any derived property are not to be treated, either, as falling within para.11(5), that is, broadly, where the chargeable person is enjoying the property in circumstances covered by the "GWR" rules, or in circumstances that would be covered by those rules but for certain specific exemptions. The effect is that the exemption from POAT in para.11(3) and the reduction referred to in para.11(4) to the appropriate rental value, appropriate amount or chargeable amount, will not apply.
41. New sub-para.(13) defines "derived property".
42. Subsections (3)(a) and (b) amend Sch.15, s.84, para.21(2)(b)(i) and (ii) which provide, in relation to land and chattels, that, where the chargeable person so elects, the property in question will not give rise to POAT charge but will be treated for IHT purposes broadly as if it were a GWR under the existing rules. In other words, the property will form part of the taxpayer's estate for IHT if they continue to enjoy it up to their death, or if they cease to do so within seven years from death. The effect is that the property will not be treated in this way where the chargeable person is beneficially entitled to an interest in possession.
43. Subsection (3)(b) inserts new para.21(2)(b)(iii) which provides (in relation to land and chattels) that, where the chargeable person is beneficially entitled to an interest

in possession in the property in question, the consequences of an election will be that ss.53(3) and (4) and s.54 IHTA 1984 (IHT exemption for settled property that reverts to settlor or, in some circumstances, to settlor's spouse or civil partner or the widow, widower or surviving civil partner) shall not apply in relation to the chargeable proportion of the property. This is intended to ensure that, where an election is made, there is an effective IHT charge on the property.

44. Subsection (3)(c) inserts new para.21(3)(a)(iii) which provides that the chargeable proportion of property in which the chargeable person is beneficially entitled to an interest in possession is calculated by reference to their date of death or, if their interest comes to an end on an earlier date, that earlier date.
45. Subsection (4) amends para.22 for elections relating to intangible assets in the same way as described in relation to land and chattels.
46. Subsection (5) provides that the amendments have effect for that part of 2005/06 beginning with 5 December 2005 and for 2006/07 and subsequent years of assessment.
47. Subsection (6) provides that, if Sch.15, para.11 ceases to apply to a person as a result of clause 80 and they die before the Finance Bill is enacted without having made an election under Sch.15, paras.21 or 22, their personal representatives may make any election the deceased might have made.
48. Subsection (7) provides that, if a person makes an election under Sch.15, para.21 or 22 as a result of clause 80, and they die at a time which means that IHT falls due before the Finance Bill is enacted, the IHT will be treated as falling due at the end of 14 days following enactment.
49. Subsection (8) provides that clause 80 is deemed to have come into force on 5 December 2005.

50. The Bill enters its final stage, with the House of Lords debate, on Monday 17 July. No amendments have been tabled for this stage. It is expected that Royal Assent will be given on 19 or 20 July.

*Comment*

51. It is difficult to discern the logic behind the adoption for POAT of some IHT exemptions and not others, e.g. use of the IHT annual exemption and small gifts exemption but no relief for gifts in consideration of marriage, normal expenditure out of income gifts, or transfers that qualify for 100% relief as business or agricultural property. This is a free-standing income tax charge which applies without regard to the motives of the taxpayer in relation to intended or actual avoidance of inheritance tax. It is an entirely new concept which draws on a mix of income tax and IHT rules and definitions and appears to have been put together hurriedly without sufficient thought (not that that's a surprise for many of us). It may affect many taxpayers who made arrangements in good faith and not primarily to avoid IHT. It is widely expected that difficulties in interpretation will emerge and there are many practical compliance problems under self-assessment.

KERRY BORNMAN

3 Stone Buildings

Lincoln's Inn

[Correct as at] 10<sup>th</sup> July 2006

[KBornman@3sb.law.co.uk](mailto:KBornman@3sb.law.co.uk)