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TAXATION OF PRE-OWNED ASSETS

Text of a memorandum submitted in October 2004 jointly by the Tax Faculty of the Institute of Chartered Accountants in England and Wales and The Chartered Institute of Taxation in response to an invitation to comment issued in August 2004 by the Inland Revenue

CONTENTS

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PRELIMINARY

1. This submission responds to the Further Consultation and amplifies the points we made at the earlier stages. We are relieved that some of the points made by us and the other professional bodies have been taken on board, and appreciate the Revenue's readiness to consult on the detailed application of the charge. Nevertheless, we remain concerned that the introduction of an income tax charge to stop inheritance tax avoidance, combined with the fact that the charge is not targeted at specific avoidance schemes but applies prima facie to all disposals since 17 March 1986 where there is continued occupation/enjoyment unless such a disposal falls within one of the specific exclusions, will mean that it is likely to be arbitrary and capricious in its effects. Our comments address the Questions in the 16 August 2004 Consultation Document (http://www.inlandrevenue.gov.uk/consult_new/tax-preowassets.pdf) including, as requested in Question 9, our other concerns with reference to points that we would like to re-emphasise and matters that we should like to see included in the Revenue guidance. We would be happy to meet with you to discuss any particular items, as necessary.

2. INTRODUCTION

2.1 We are disappointed that the Further Consultation states that "the further regulations must cover two matters in order for the charge in Schedule 15 to be fully operational at the beginning of tax year 2005-06.

- A valuation date must be specified for all assets in each tax year from 2005-06 onwards;
- a rate-of-return must be specified for chattels and for intangible assets from 6 April 2005 onwards.

"In both of these respects the primary legislation is compatible either with the uniform rates or assets in question or with regulations specified on distinct dates."

2.2 The actual vires for the regulations are in FA2004 Schedule 15, para 20. Sub paragraph (1) provides:
"Regulations under this schedule may
(a) make different provision for different cases, and
(b) include transitional provisions and savings."

Sub paragraph 20(2) states:
"Any power conferred by this Schedule to prescribe a rate of interest includes power –
(a) to prescribe different rates in relation to property of different descriptions, and
(b) to prescribe a rate by reference to a rate specified in the regulations."

2.3 Our key point is that paragraph 20(1)(b) provides that regulations may include transitional provisions and savings. There is no mention of this in the Consultation despite our specifically requesting the Paymaster General to include it in order to address some of the problems that will arise under this legislation. Accordingly, this provision was duly included in the Finance Act. We do not think that it is proper for the Revenue to ignore these points when considering the regulations.

2.4 Before responding to the Questions specifically, we wish to make general observations about the difficulties both of arriving at any valuation and one at any given date. There seems to be a supposition that where a valuation is obtained then that figure is a fair one on which to levy taxation: to our mind this is a total non-sequitur. These considerations have informed our responses to the Questions.

3. THE NATURE OF A VALUATION

3.1 Valuation is very much an art rather than a science: in reality, a valuation is no more than a highly subjective opinion. We regret the assumption in the Consultation that a valuation provides any degree of precision. *Langham v Veltema* has confirmed that even where a professional valuation is used the valuation may be challenged, and anyone of any experience of negotiating with the District Valuer or Inland Revenue Shares Valuation knows that even an agreed valuation is no more than a compromise between two highly subjective valuations.

3.2 Chattels are notoriously difficult to value. Experience shows that, even where professional auctioneers have given a guide price (which itself is usually stated as a range between the highest and lowest expected result that can easily differ by 100%), many items fail to reach their reserve price; others are sold for more, and in some cases for very much more, than the auction guide price would suggest.

3.3 Most of the problems in relation to chattel valuation also apply to the rental value of land. The assumption seems to be that this would not give rise to a problem because there is a ready rental market for many properties. Whilst this may be true in some cases, it is certainly not true for all properties. We have been told of a case where the rental values applied to a particular property by two of the country's largest firms of Chartered Surveyors differ by more than 25%.

3.4 The cases on share valuation which have actually gone to court suggest that the difference between the opinions of professional valuers of unquoted shares may well differ by a factor of 4 or more as to the capital value of the assets; this shows that unquoted shares are at least as difficult to value as land or chattels and therefore, in respect of such intangible assets, the need for just and reasonable valuation rules is imperative. It also suggests that the taxpayer should have the option of not being forced to revalue each year.

3.5 Other intangible assets, such as goodwill, are rarely owned by settlor-interested trusts, but where they are the value of goodwill is just as subjective as that of unquoted shares. Intellectual property such as patents, trademarks and copyrights are more frequently held in trust. They are assets for which there is only a very limited and specialist market, if one exists at all, with similar problems of valuation. We therefore think that a special valuation regime should not be restricted to land and chattels, but should extend to intangible assets which are not quoted on a recognised market.

3.6 Furthermore, the DV element of the calculation is by no means straightforward even if the rental value can be ascertained. For example, the value of what has been given away in *Ingram* schemes can take years to agree on the death of a person. Similarly, in *Eversden* schemes, the value of an undivided gifted half share will not necessarily be 50% of the whole, taking into account the co-owner's rights of occupation.

4. THE VALUATION DATE

4.1 Considerable injustice would result from a charge that is based on a valuation (by its very nature an imprecise estimate) fixed on any arbitrary date. Not only is the market volatile for many chattels, but also income tax, as an annual tax, does not lend itself to such an approach. The following two examples illustrate this point.

4.2 A classic Ferrari bought at arm's length in 1989 for £700,000 was sold 3 years later for £100,000. In that period, the car had hardly been used and had not changed in any way, but the market for classic cars had suddenly crashed and, in general, has never recovered to its 1989 levels.

4.3 A collection of early Islamic glassware was professionally valued at £600,000 for the entire collection, consisting of approximately 50 items. The collector was subsequently offered $2m by an American collector for two pieces from the collection, which were not considered necessarily to be the most valuable items in the collection.

4.4 The Consultation recognises that for assets such as insurance policies, the value provided on an anniversary statement might provide a convenient starting point.

4.5 It is worth remembering that the only real value that can be placed on many assets is the price at which ownership changes hands. Therefore, we believe that the chargeable person should be allowed to choose an alternative method of valuation, being the actual cost price indexed in accordance with the general index of retail prices. Whilst it is obvious that the retail prices index is not an accurate indication of the fluctuations in value of any particular asset, it is an objective figure that is readily available. With many assets there is no appropriate index, or such index as exists is based on an inadequate or skewed sample that is unlikely to make it satisfactory for general tax return purposes. The cost price (or probate value if the asset is inherited) at least provides some definite starting point.

CONSULTATION QUESTIONS 1-8

5. Question 1
Ministers propose that the "valuation date" for purposes of Schedule 15 should, as a general rule, be 6 April of the tax year in question, or if later the first day of the "taxable period" for the asset in question. Do you agree that this should be the general rule?

5.1 At paragraph 9, the Consultation explains that the capital value of caught assets will directly affect the charge in the case of chattels and intangible assets, but not generally in the case of land. Thus, the way the valuation date is fixed is likely to be material in the case of chattels and intangibles. Paragraph 10 recognises that the value of chattels will generally be subject to quite wide margins of uncertainty. We regret that the Consultation, having identified the problem, does not suggest any solution.

5.2 We accept that, subject to the chargeable person having the right, each year, to elect for one of the other bases described below, 6 April or, if later, the first date of the taxable period for the asset in question, should represent the default position. Without such right the injustice inherent in the charge would be magnified.

6. Question 2
If not, what should be the alternative?

6.1 Because of fluctuations in the chattels market in particular, and for the values of land and intangible assets also, we think a fixed 6 April valuation date may operate unfairly. We believe that the chargeable person should have the right, each year, to choose as an alternative the average of the valuation at the beginning and end of each fiscal year or date of acquisition and end of year where the asset was acquired during the year.

6.2 We strongly believe, however, that there should be a general override allowing the valuation on a just and reasonable basis where appropriate, perhaps as a result of a material change in the market during the year or in the value of a particular asset: for example, doubts cast on the attribution of a picture could decimate its value overnight. This would also cover assets that may have a natural valuation date such as intangibles (for example, policy anniversary date), and cases where a value may have been established during the year (for example, sale of unquoted shares). A just and reasonable override would enable such cases to be covered by guidance as and when they are identified without having to change the regulations on a regular basis, with the result that they become far too complex for anyone to self assess.

7. Question 3
Are there, in any event, particular cases which call for special treatment, either in the regulations or in guidance?

7.1 We are concerned that the costs of compliance, and in particular of obtaining valuations, will be disproportionate. A professional valuation of chattels is likely to cost 1% or 2% of the value depending on the type of asset. If the rate of return for chattels is fixed at a remotely commercial level of, say, ½ - 1% of the value of asset, the tax charged at 40% would be 0.2% to 0.5% of the value, which would cost between 1% and 2% to obtain. It is clearly unreasonable to expect the taxpayer to incur costs in complying with a tax of several times the tax stake. If, however, he does not submit a professional valuation, then *Langham v Veltema* effectively means that the self assessment could not be closed as the Revenue would be able to make a discovery.

7.2 We therefore think it is essential that in a self assessment regime chargeable persons be allowed to use a valuation that is readily ascertainable. In many cases this will be based on the insurance value of the asset. Taxpayers are unlikely to materially under-insure merely to reduce a tax bill, as this would defeat the purpose of insuring.

However, insurance values are normally based on estimated replacement values, and many dealers in valuable and exclusive chattels operate on a profit margin of between 100% and 200%. This would suggest that the Regulations allow taxpayers to use, say, one third of the replacement insurance value as the value of the asset as an alternative to a professional valuation or estimating the value themselves.

7.3 Given the inherent lack of precision in any valuation, we feel that, for the purpose of charging tax on pre-owned assets, the self assessment regime must be tempered so that, provided an estimate or valuation is submitted honestly, the taxpayer is not liable for penalties and is granted finality after the normal enquiry window.

7. 4 A further difficulty in the valuation of chattels in particular is the lack of records in many cases. It has only been necessary for IHT purposes to keep records of gifts for seven years. For this reason, we maintain that the start date for chattels should not be 1986 but 6 April 1998 (ie seven years prior to the commencement date of 6 April 2005), which is also the start date for taper relief for CGT purposes.

8. Question 4

Do you agree that any special valuation regime should be restricted to land and chattels? If so:

a) should it extend to intangible assets; and

b) which ones should it apply to; and

c) why?

8.1 Our response to this Question follows from our concern at the disproportionate costs of valuation expressed at Question 3. There, by way of example, we gave illustrative costs in relation to chattel valuation. The figures would not be wildly dissimilar in obtaining a Chartered Surveyor's opinion of rental value of land or the DV value, or a Chartered Accountant's opinion of the value of shares in an unquoted company, or an expert's opinion on a copyright.

8.2 Most settlor-interested trusts encountered by members own shares in family companies where the income tends to be accumulated rather than distributed, and is taxed under TA 1988 s660A. Settlements that merely contain quoted shares and similar investments are not normally settlor-interested, except in the case of excluded property trusts for non-domiciliaries. The valuation of shares in unquoted companies is very much an art rather than a science, where the views of different valuers will produce very substantial differences in the capital value of the assets.

8.3 Valuation at longer than annual intervals would appear to be a necessity to keep down general compliance costs. An RPI revaluation would be relatively simple to apply, but it could be most unfair in some cases and therefore it should be available at the taxpayer's option. Taxpayers are likely to know whether there has been a significant change in the value of assets such as to make it worthwhile to incur the costs of valuation in order to determine an alternative valuation. We would not have thought that the loss to the Exchequer by allowing the taxpayer to choose would be material given overriding considerations of fairness, and that any such 'cherry picking' would come at a substantial compliance cost to the taxpayer in terms of having to pay for professional valuations.

8.4 Therefore, once a valuation has been obtained, and the cost borne, we think that the chargeable person should (if they wish) be able to rely on it for a reasonable period. In this context we believe a five-year period, during which a valuation could be adjusted in line with the RPI, could not be considered excessive. Thus, the taxpayer could opt into the RPI regime for a period of, say, five years, and he could then review the decision after that date.

8.5 We conclude that a special valuation regime should not be restricted to land and chattels. but should extend to intangible assets which are not quoted on a recognised market.

9. Question 5
Do you accept that a special valuation regime would be compulsory for eligible assets; or would taxpayers always want the option of a strictly annual valuation?

9.1 For reasons outlined above, we do not think that a special valuation regime should be compulsory for eligible assets. It is our firm belief that taxpayers should have a choice from various bases of valuation. However, a voluntary regime with options that include indexation is clearly fairer than a compulsory system with valuations every few years.

10. Question 6
Are either of the options [compulsory 3 year fixed valuation for land and chattels or voluntary, indexed and 5 year cycle] attractive?

10.1 This answer largely covers ground addressed in Questions 4 and 5. We maintain that, unless the taxpayer has the flexibility (at his cost in valuation and compliance terms) to choose different bases of valuation, for different assets, in different years, then the unfairness of a charge based on an arbitrary figure becomes ever more manifest.

11. Question 7
Are situations like this likely to arise in practice? If so, how could they be accommodated without risk to the Exchequer, either in the regulations proper or in our operational guidance?

11.1 In the case of land where rent reviews take place, say, every five years, there will be an actual change in the rental value only every five years. Where, therefore, a charge is based on the theoretical rental value of land, it seems reasonable to assume that, as in the real world, a deemed market rent on day one should remain unchanged and unindexed for, say, five years, and then be reassessed; indexation is inappropriate where valuation changes take place at longer, discrete intervals.

11.2 Cases of this nature prove the necessity (as suggested above) for a general override allowing for valuation on a just and reasonable basis where appropriate.

12. Question 8
Do you have comments on [imputed yield on chattels or intangible assets] or do you have any other points which you think would inform Ministers' judgement on these rates?

12.1 It is essential that the imputed yield on chattels should take into account the actual yield on chattels that are let. One of the fallacies of the system is that the chattels likely to be subject to the new regime, for example paintings, antiques, historic cars, etc, are not those for which there is a ready letting market. Many works of art are lent to public museums on the basis that the museum is responsible for security and insurance but does not otherwise pay for the use of the chattel. This would normally work out at between ½ and 1% of the capital value of the asset, and there seems no reason why, if an asset is given away within a family such that the asset continues to be available to the donor, and therefore within these provisions, the imputed yield should be different from that available in the open market.

12.2 Assuming the donor pays for the insurance and provides the security for the asset, a yield of ½ to 1%, depending on the type of asset, would not be unreasonable. A flat rate applicable to all would be inappropriate since, for example, a market rate for works of art is likely to different from general household furnishings. Similarly, for intangibles, realistically one would expect the yields on different classes of shares to differ; and on shares in different types of company (for example trading as against property company).

12.3 Similarly, assets such as classic cars are often lent to other people to drive, as the capital value of the asset is maintained by keeping it in the public eye and emphasising its historic attributes. In some cases, the owner of the asset will actually pay another driver to drive the car; in other cases, it would be on a "benders/menders" basis, under which the person to whom the asset is lent pays for the cost of insuring it or the cost of repairs if it is damaged.

12.4 The suggestion that any of these assets yield a return of anything approaching the official rate of interest for employee loans is based on a false premise and should not form the basis of a taxation charge. Our members have identified no instance of chattels obtaining anything remotely approaching such a yield. Please make public the evidence which shows any correlation with the official rate of interest.

12.5 We believe that the proposed level of charge on intangible assets is unrealistic. It is accepted that any actual benefit obtained by the settlor in a settlor-interested settlement is already subject to income tax or capital gains tax under the existing provisions of TA 1988 s660A or TCGA 1992 s77. What is now being taxed is "the comfort from those assets being available to the taxpayer". However, in many cases the assets in a settlor-interested trust are not available to the settlor except in exceptional circumstances, such as the death of the life tenant *and* remainderman. Many such trusts have been set up to provide for elderly relatives with the expectation that the asset will come back into the settlor's inheritance tax estate under the revertor-to-settlor provisions when the elderly relative dies. In the meantime, the assets are certainly not available to the taxpayer. Similarly, where the taxpayer is merely an ultimate default beneficiary, for example he can benefit only if all of his children die, the "comfort" of benefiting is only a remote possibility.

12.6 We believe there is a fundamental flaw in the whole of the paragraph 8 charge in respect of settlor-interested settlements. On any actuarial apportionment the value of the settlor's retained interest is tiny in comparison with those of the current beneficiaries. The value of the "comfort", therefore, is also very small, and cannot be said to equate in any manner with the actual value of the assets in the trust.

12.7 The valuations will be difficult because it is necessary to value a remainder interest that will be exempt from the charge under paragraph 11(2) when assessing the tax on the settled property – the remainder interest is deductible in assessing values.

CONSULTATION QUESTION 9

13. Question 9
Do you have further points that you would like to see covered by our guidance, or are there any other points that you would like to re-emphasise?

13.1 We welcome this opportunity to raise a number of miscellaneous matters.

14. Multiple charges

14.1 We are concerned about the provisions relating to land and the multiple charge that can apparently arise, notwithstanding Schedule 15, paragraphs 17 to 19. We have been provided with the following facts:

14.2 In 1990, a grandfather gave his son money to buy a family villa in Portugal, which he duly did. As the grandfather provided the money for the purchase and visits the property every year for a total of 3 or 4 weeks, he would seem to be caught under the contribution condition and taxed on the rental value of the property. There is no formal lease and he pays no rent, and it therefore seems that he may be liable to UK income tax on the total rental value of the property for the year, in spite of his short period of actual occupation, unless the property is occupied by another during the year. We suggest that there should be a de minimis exemption along the lines of reservation of benefit to cover such cases, and we would welcome clarification of the Revenue's view of the meaning of occupation in the guidance note. We would also welcome clarification of what happens if the donor only occupies or has the right to occupy part of the original property gifted.

14.3 Portugal decided to introduce an annual capital tax on such villas, and the son transferred the property to a Maltese company in exchange for shares which he settled on an interest in possession trust for his minor children, caught by TA 1988 s660B. The son also arranged for letting the property when not in use with the Portuguese agent, and supervises the maintenance of the property when in Portugal. He and his family occupy the house for 3 or 4 weeks; it is let for about 4 months, and is vacant for the remainder of the year. Because of his activities on behalf of the Maltese company, the Revenue argue that he is a shadow director, under *R v Allen*, and therefore subject to a benefit in kind on his occupation of the property.

14.4 The ability to self-assess such deemed income of a subjective amount must be uncertain. We are concerned that compliance may be rather less than is desirable.

15. Transitional election

15.1 We cannot see the necessity for the transitional election under paragraph 21 being made by 31 January 2007, which seems to be the effective return date under paragraph 23. In many cases taxpayers (particularly the unrepresented) may not appreciate that they are within the pre-owned asset charge. We would therefore like to see the election being available for a much longer period, ie five years and ten months from 5 April 2006, in the same way as for many other claims for losses or reliefs. Such election would have the dual effect of bringing the taxpayer into the gift with reservation regime as from the earlier year, and would consequently absolve the taxpayer in respect of the pre-owned assets tax and penalties for any reporting failure in respect of that earlier and subsequent years.

15.2 The legitimate expectations of a settlor caught under paragraph 8 under the settlor-interested settlement provisions need to be considered. When making an election under paragraph 22, he is treated as reserving a benefit in the whole settled property as well as being taxed separately on the value of the remainder interest. This potential double charge should be covered in the Double Charges Regulations.

16. Distress caused to families with joint occupation, etc

16.1 We are aware of the concerns of many families where domestic arrangements are entered into, not for IHT avoidance, but for family support and care. The main problem areas involve shared ownership such as granny annexes or just plain houses. Two examples follow:

16.2 *Example 1*
Mrs A occupies a house, value £300,000, with her adult daughter. Mrs A owns 50% of the property, and the other 50% is owned by her nephew. Mrs A owns another property jointly with her nephew, which the nephew lives in. Arrangements are historic (inheritance long ago). To tidy things up, Mrs A wants to give her half share in the other property to her nephew, and for the nephew to give his half share in their occupied property to her daughter. This is also intended to give her daughter security, as her siblings may try to eject her from the house on Mrs A's death.

16.3 It appears that a POA charge would apply (indirect contribution). This seems harsh, bearing in mind the daughter is occupying the property.

16.4 *Example 2*
Mrs B sells her house and gifts the cash, and the money is used to buy a larger house with her daughter, son-in-law and family. The new house is in the daughter's and son-in-law's names. The amounts are below IHT levels. This arrangement is very common, and has worried many people who are needlessly being put to expense and distress. Most probably, some of them will not know about it or do anything. It is not caught by reservation of benefit rules, and therefore there is no exemption from POA.

16.5 Electing is probably the answer, but Mrs B may not know she has to elect. Whilst in some cases the situation may be covered by de-minimis thresholds, we consider that such cases should be outside the POA charge, and that a higher de-minimis threshold or, better, a specific exemption or concession in the guidance notes is required.

17. Specific points on which guidance required

17.1. The meaning of occupation, as indicated in the questions above.

17.2. Why should the provisions on non-exempt sales have to be limited to cash consideration? Exchanges of property are common and not covered here.

17.3. The limitation on the paragraph 10(1) exclusion to sales of the whole asset should be reviewed as a matter of urgency, with some definite statement by the Paymaster General. Equity release schemes between members of the family as well as with commercial providers are very common. The Paymaster General has undertaken to review this area, and it appears to be iniquitous that sales of part are not protected if done for full consideration.

17.4. Please clarify the meaning of 'substantially less' in paragraph 11(1)(b): is it 20%?

17.5. Please confirm in the guidance note that paragraph 11(5)(d) is intended to mean that the full consideration exemption is available for both chattels and land. Is it permissible to protect this exemption with a price adjuster clause, as was the case for offshore trusts?

17.6. Can the guidance note confirm that paragraph 12(3) is not meant to prevent paragraph 11 from applying to foreign domiciliaries?

17.7. Why should taxpayers be exposed to a double inheritance tax charge if they elect back into the inheritance tax regime under paragraphs 21/22? For example, in relation to home loan schemes, if the donor elects and then dies within seven years of the gift, inheritance tax is payable both on the debt and the value of the house. In relation to *Eversden* schemes, if an election is made there can be double charges if the settlor and his spouse die, because the spouse has made the PET and the settlor now has the asset in his estate for inheritance tax purposes. The double charge on remainder interests where there is a paragraph 8 charge has been referred to already. We understand that one of the objects of introducing the POA charge is to persuade taxpayers to elect back into the IHT regime, but double charges such as arise here will deter taxpayers from doing so. We suggest that the Double Charges Regulations 1987 could be amended to cover these points and give relief against a double charge.

17.8. Can the Revenue confirm their view as to whether the spouse exemption is ever potentially available on property which is subject to a reservation of benefit (ie property on which an election has been made)? If not, then the married taxpayer will undoubtedly be in a potentially worse position. Again it will deter persons from electing.

17.9. Why should there be no exclusion from the intangibles charge for settlors where the spouse has a continuing interest in possession? Would the Revenue contemplate amending the legislation to allow for this in the future?

17.10. Please can the Revenue confirm whether or not a transaction is only excluded under paragraph 10(1)(c) if the spouse takes an initial interest in possession in the settled property, or whether it is sufficient that he takes an interest at some point for the protection to apply.

17.11. Please confirm that paragraph 16 gives exemption in relation to deeds of variation where the surviving spouse took absolutely under the Will but now varies the Will to create a life interest for the spouse. There is no transfer of value as such under s17.

17.12. Please can the guidance notes deal with the reasonable attribution rules under paragraph 4(2)(b), and in particular give some examples of how these will operate in practice.

17.13. Please can the guidance notes clarify what happens if the taxpayer pays the income tax liability under a mistake of law. Can he reclaim it if it turns out that he is within the reservation of benefit rules or for any other reason not caught by POA?

17.14. If the taxpayer is under the genuine, albeit mistaken, belief that he is not within the POA regime, and it turns out later that he is, can the Revenue confirm that this will be accepted as a reasonable excuse for making a late election, at least in the initial years of the POA regime?

18. CONCLUSION

18.1 The reason for introducing these provisions is apparently the difficulty of making the gift with reservation rules operate satisfactorily. We are disturbed that the anti-avoidance Pre-Owned Assets regime, so far as it affects actions that have taken place before these rules were first promulgated, is :

- retrospective in its effect;
- disproportionate to the mischief at which it is purportedly aimed;
- contrary to taxpayers' legitimate expectations;
- arbitrary as based on unquantifiable concepts.

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