Tax Representation

TAXREP 09/04

TAX TREATMENT OF PRE-OWNED ASSETS

Memorandum submitted in February 2004 by The Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document issued in December 2003 by the Revenue

Contents

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GENERAL COMMENTS

1. We welcome the opportunity to comment on the consultation document published by the Revenue on 11 December 2003 on the web at http://www.inlandrevenue.gov.uk/consult_new/index.htm

The underlying principle

2. We accept that questions of tax policy are entirely a matter for Government to decide. However, we believe the proposals outlined in this consultation document are wrong in principle and will prove impossible to administer.

Properly targeted legislation: strengthening the GWR rules

3. If the Government is concerned that arrangements are being effected to get round the gift with reservation (GWR) rules, then we consider that the appropriate remedy is to strengthen the GWR rules rather than introduce a totally different tax charge. As outlined further in our detailed comments below, the proposals are retrospective, unfair, unworkable in practice and arbitrary. We urge the Government to reconsider the underlying policy behind these proposals and instead bring forward properly targeted measures to strengthen the GWR rules.

4. We would like to understand the Government's concerns about the existing GWR rules and in what circumstances the Government does not believe they operate as intended. We would wish to co-operate in exploring ways in which the existing GWR rules could be strengthened to address these concerns.

Problems with an income tax charge

5. If the proposal to introduce an income tax charge is not modified, a number of problems need to be addressed.

Double charging

6. Firstly, the proposal could result in double charges arising. For example, transfers of assets may in any event be subject to the GWR rules, with the result that the asset remains in the estate of the taxpayer for IHT purposes. In addition, they may have been subject to capital transfer tax (CTT) or inheritance tax, even at nil rate. We think that all of these circumstances should be exempt from this new charge. Consideration needs to be given to providing relief from this new charge where capital gains tax may have been paid on the disposal.

Self assessment

7. Given that the proposed new charge is intended to be based on market values for real property and capital values for other cases, it will not be easy for taxpayers and the Revenue to work within the self assessment regime. A tax that is considered to be unfair as well as being difficult to comply with will lead taxpayers to question why they should comply. From there it is but a short step to evasion or protest, as with the poll tax.

Ability to pay

8. The proposal to apply an income tax charge could well result in tax charges arising on those without the means to pay the tax. Any tax charge introduced should be fair and reasonable.

The need for proper consultation

9. We are concerned that the intention to include this new legislation in the 2004 Finance Bill will leave insufficient time for proper consultation. On past experience, this will result in poor legislation which will require either amendment or Revenue practice statements and other expedients to make it workable.

10. We consider therefore that before draft legislation is put before Parliament, there should be proper consultation to ensure that, as far as possible, any new charge should comply with our ten tenets for a better tax system which are summarised in the Appendix.

Deferral until 2005

11. In order to allow time for proper consideration of the issues and for alternatives to be examined, we recommend that the changes are deferred for a year and that any primary legislation is included in the 2005 Finance Bill.

DETAILED COMMENTS

Retrospection

12. The charge is expressed in the consultation document as applying to pre-owned assets that are enjoyed by the former owner. It will therefore apply to existing pre-owned assets. As this charge will be imposed with reference to events which took place in the past, this is retrospective taxation.

13. We understand that this is the intention and we urge the Government to reconsider as we believe that retrospective taxation is wrong in principle and in many cases could create hardship. For example, it may be impossible to undo transactions entered into in the past. There are likely to be stamp duty land tax and other tax issues making unscrambling financially impractical.

14. We believe that any new charge should apply only to assets given away from some future date, for example 6 April 2005.

Double taxation

15. There are various situations where the charge will apply to gifts that either remain subject to IHT as a GWR or were subject to CTT or IHT.

16. We consider that where a gift of an asset has been made and the transferor remains liable for IHT or paid CTT or IHT, then the fact that he can still use the asset should not render the transferor liable to this proposed new charge. We also think that the charge should not apply where the transfer was subject to CGT.

17. If the Government considers that assets that are not caught by the GWR rules but are still used by the donor should be taxed, then the answer is to amend the GWR rules to cover them, not apply an income tax charge.

18. In addition, the new charge will apply to a number of situations where we do not think that it should apply. We have set out below an number of examples where we think the charge should not apply as it will be retrospective, potentially unfair and could cause real hardship:

- Pre-1986 gifts: a father gave his son a picture in 1985 which is still in the father's house. CTT was paid. The payment of CTT should exempt him from the new charge.

- Estates in nil rate band: a widower gives his £200,000 house to his son (his other assets total £20,000) and continues to live in it. He has not 'expressly reserved a right of continued occupation when making the gift'. The fact that IHT is payable, albeit at 0%, should exempt the widow from the new charge.

- Gifts between spouses: husband gives half his house to his wife and continue to live in it, he may then inherit it back on her death. Another example: a husband may give a let property to his wife which she continues to let out; he then inherits it on her death and continues to let it. We see no reason for a new charge to apply in these circumstances.

- Sales to connected persons: mother sells house to son for full market value and continues to live in it. This transaction should be treated no differently from a sale to an unconnected third party.

- Gifts of property attracting business property or agricultural property: farmer gives farming business including farmhouse to sons but he continues to live in the farm. Agricultural property relief is available so that no IHT is payable on his death.

- Life interest trusts: Mr A places an asset in a life interest trust of which he is the life tenant. This may be because he is elderly and fears senility and wants others whom he trusts to look after his assets for him to protect his assets from dissipation.

- Cases where a charge will arise under the CGT rules, for example in cases where the CGT capital payments rules may be in point (see for example *Billingham v Cooper* [2001] STC 1177)

- Gifts to the National Trust and similar bodies, where continued occupation is the norm.

- Use of a partnership asset by the former owner, for example in the case of a farmer who uses some of the partnership assets which were formerly his in his own separate farming sole trade.

Equity release schemes

19. Equity release schemes provide an opportunity for homeowners to release some of the value locked up in their homes by selling an interest in it for cash whilst continuing to live in it. Although it appears that such arrangements will not be subject to this new charge, we would be grateful for confirmation that they will not be caught.

Excluded property trusts

20. We would also welcome clarification of whether the new charge is intended to apply to the settlement of a trust of foreign situs property by a non-domiciled individual such that the property is excluded property for the purposes of IHT.

Clarification of terms used in the consultation document

21. We would welcome clarification of the meaning 'expressly reserved a right of continued occupation when making the gift' (the third bullet at the end of page two of the consultation document).

22. We would welcome clarification as to how 'use' would be quantified in the following circumstances:

- Deeds of variation: a beneficiary under a will gives away his inheritance and makes the necessary statement under section 142(2), IHTA 1984 but continues to use it.

- Trusts involving life assurance policies and similar intangible assets.

Charge under Schedule D Case VI

23. The charge will be under Schedule D Case VI. We trust that taxpayers will be able to offset any Schedule D Case VI losses against any charge under this provision.

24. The charge should also be subject to the remittance basis (suitably modified) as would apply to income of non-domiciled individuals taxable under Schedule D Case IV and V.

Valuation of benefit

25. The consultation document states that real property will be valued at market rent and other assets at a percentage of capital value. Valuations and self assessment are not always compatible as it can take a great deal of time and expense to agree valuations with the Revenue that are fair to both sides. It is an essential part of a self assessment system that taxpayers can self assess with certainty. However, this will be impossible unless some objective measure or method of arriving at valuations is used.

26. If values have to be reassessed every year, then this is going to result in excessive compliance costs. If values need to be agreed annually with the Revenue, then this will result in costs for both taxpayer and the Revenue.

Assets only partially used

27. Where an asset is only partially used by the pre-owner then the benefit charge should be apportioned. For example, a pre-owned house which is lived in with one other should be charged at half the benefit.

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APPENDIX

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory**: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. **Certain**: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. **Simple**: the tax rules should aim to be simple, understandable and clear in their objectives.

4. **Easy to collect and to calculate**: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. **Properly targeted**: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. **Constant**: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. **Subject to proper consultation**: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. **Regularly reviewed**: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. **Fair and reasonable**: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. **Competitive**: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.