

# PRE-OWNED ASSETS - THE POA INCOME TAX CHARGE ON GIFTS

## JOHN M TAYLOR & CO

CHARTERED ACCOUNTANTS & BUSINESS ADVISORS  
9 GLASGOW ROAD, PAISLEY, PA1 3QS  
TEL: 0141 848 7474; FAX: 0141 848 7419;  
EMAIL: MAIL@JOHNMTAYLOR.CO.UK



### Pre-Owned Assets Regime

The Government has been aware that in recent years many schemes have been marketed which use artificial structures to circumvent the inheritance tax gift with reservation of benefit rules. These schemes are designed to avoid inheritance tax and people have been able to strip the assets out of their taxable estate for inheritance tax purposes whilst continuing to enjoy the benefits of ownership.

The Finance Act 2004 introduced a new income tax charge which will apply wherever a person enjoys a benefit from assets which they:

1. Formerly owned, or
2. Provided the funds to purchase, but which they no longer own.

This income tax charge ("the charge") applies where, in the case of:

- Land - the taxpayer occupies the land and either once owned it but gave it, or an interest in it, away. Similarly, if the taxpayer gave another person funds to purchase the land, or an interest in it; or owned other property which was sold and the proceeds used by another person, directly or indirectly, to buy the land then the charge applies.
- Chattels – the taxpayer possesses or has use of the chattel and either once owned it, but gave it, or an interest in it, away; or gave another person the funds to buy it or an interest in it. Similarly, the charge also applies if they owned other property which was sold and the proceeds used by another person to buy the chattel.
- Intangible Property – assets such as shares or insurance policies are held in a settlement and the person who gave that property to the settlement may benefit from it.



The income tax charge will be charged from 6<sup>th</sup> April 2005 and will be broadly based upon the existing benefits in kind legislation. The tax charge will be applied against an amount equivalent to the annual cash value of the benefit and there is a de-minimis limit of £5,000 per annum. Although this tax charge comes into effect from 6<sup>th</sup> April 2005 onwards it will be imposed against schemes that were already in place before this tax charge was introduced.

### Examples

1. In 1995, John gifted the family home to his daughter Sally when it was worth £400,000. In 2004 it is now worth £800,000 and Sally decides to sell the house. She does so and uses some of the proceeds to buy her father a house in which he now lives, rent-free, during the 2006/07 tax year. The initial gift in 1995 triggered the disposal condition. As the proceeds of that sale were subsequently used to purchase the property in which her father now lives a POA Tax charge applies, on the basis of the rental value that the property would receive on the open market.
2. The facts are the same as the example above except that John gave his daughter a cash gift of £400,000 in 1995 which Sally subsequently used to buy the house in which John now lives. Again the POA Tax charge applies as the contribution condition has been satisfied.

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## Pre-Owned Assets Regime

### Tax Charge

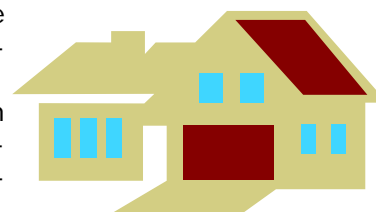
In cases where the tax charge applies the taxpayer will be treated as though their income is increased by the value of the benefit that is deemed to be received. For example if the asset in question is a property which would reasonably be expected to receive an open market rental of £18,000 the cash benefit is deemed to be £18,000 and will be taxed as his top slice of income. Where it is only a share of an asset that has been given away then the deemed benefit will be reduced proportionately.

If the taxpayer is legally obliged to make a payment during the taxable period in respect of the benefit this payment will be taken into consideration. Where a full market rent has been paid then the benefit will be reduced to nil.

### Exemptions

This tax charge will not apply where:

- The disposal occurred before 18<sup>th</sup> March 1986.
- The property has been given to, or to a trust for, the spouse of the taxpayer, unless the spouse's interest terminates in his/her lifetime.
- The property, or other property deriving its value from it, is still included in the estate of the taxpayer for inheritance tax purpose under the existing gift with reservation rules.
- The property was sold by the taxpayer at arms length i.e. at a commercial price.
- The taxpayer provided money to another person to buy the land or chattels concerned, the gift of money was made at least seven years before the taxpayer started to occupy the land.
- The taxpayer was formerly the owner of the property only by virtue of a will which was varied for Inheritance Tax purposes.
- The disposal was of a share in land, including a house, to a person who occupies it with the taxpayer.
- The taxpayer is resident but non-domiciled in the UK, and the property in question is located outside the UK. If the taxpayer becomes domiciled in the UK then the tax charge does not apply to any non-UK assets which they ceased to own before they acquired that domicile.
- The value of the benefit on which the income tax charge arises is less than £5,000.



## Arrangements caught by the Tax Charge

A number of previous tax arrangements were successful in removing an asset from an individual's estate but these now fall foul of the pre-owned assets legislation. Some examples are:

- Shearings schemes where a taxpayer gave away a freehold of his home retaining a rent free lease intended to last his lifetime.
- Schemes where chattels are given away and leased back to the owner at a rent less than the current market rent.

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### Pre-Owned Assets Regime

#### **Arrangements caught by the Tax Charge (cont'd)**

- The 'double trust' or 'home loan' scheme where a taxpayer's home is sold to a trust but the price is left outstanding with the debt given to a second trust for the taxpayer's children.
- Arrangements under which the taxpayer has given an interest in land he occupies, e.g. the freehold, to his children or to a trust.
- Reversionary lease schemes where the taxpayer retains ownership of the property but gives away a lease usually commencing in 21 years time.

#### **What can you do if you are caught by the POA rules?**

##### Pay An appropriate rent

If you pay a market value rent to the new owner of the property in question. Not only will this avoid the POA charge but it will also further reduce the value of the estate for IHT purposes. However, this will be more costly than paying the POA charge at 40% of the market value rent.

##### Pay full consideration

Rather than gift the property if the donee pays full consideration for the asset no POA charge will be applicable. However, from an IHT planning perspective this route does not alter the value of the estate.

##### Pay the POA Charge

Paying the POA tax charge will preserve the benefit of any successful IHT planning that has been done but at a cost. However, if the new owner is a 40% taxpayer, paying them a full market rent will result in a 40% tax charge in any case so there is no real difference here.

If the POA Charge is paid it is vital to ensure that there are no GWR (Gift with reservation of Benefit) issues as if HMRC decide that the GWR rules apply the asset is deemed to remain within the original owner's estate regardless of the tax charge paid.

'Gift with reservation of benefit' - A gift with reservation of benefit is where an asset is gifted but it is not fully given away so that either:

- the person getting the gift does so with conditions or restrictions attached, or
- the person making the gift keeps back some benefit for themselves.

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Where such a benefit is reserved the asset is deemed to remain within the estate of the donor for IHT purposes. The Pre Owned Asset regime has been introduced to extend the GWR legislation to close off various loopholes that have been exploited by the various tax arrangements discussed on page 2.)

#### Give up the benefit

If possible it may be best if the donor can relinquish occupation of the property or give up use of the asset. Where this is not realistically possible, for example with a family home, it is possible that a smaller living unit such as a self-contained flat can be created within the home such that the rest of the home can be given away. This would mean that the individual only had use of the smaller unit and the resulting market value of the asset involved is reduced, possibly even below the £5,000 de-minimis limit.

#### Opt out of the POA Regime

Alternatively, if the POA charge is too costly and it is not possible to either pay the market value rent for the asset or to receive full consideration for it a final option available is for the donor to opt out of the POA regime. For someone who would otherwise be taxable under the POA regime in 2005/06 this election must be made by 31st January 2007. This will result in the asset falling back within their estate for IHT purposes until such time as the reservation of benefit ceases. At this point the transfer will become a potentially exempt transfer and the asset will become exempt if the donor survives the date of transfer by seven years.

### Will it effect you?

The 2005/06 tax year was the first year in which the POA tax charge arose. However, the Inland Revenue have actually published very little in the way of guidance in the Self Assessment guidance notes. If you think the POA legislation may apply to you and would like advice on what your options are and the benefits of the various options please give us a call so that we can work out what is best for you. Alternatively if you are completing your Self Assessment Tax Return and would like some guidance on how to calculate your POA Tax Liability please don't hesitate to contact us.

#### **Disclaimer**

*This article is intended to give a brief overview of the new Pre-Owned Assets Legislation. It has been produced on the basis of our understanding of the legislation at the time of production.. However, the reader should ensure that the information contained in this article is verified before acting upon it. This article is in no way intended to be professional advice. If you have any queries regarding this topic or would like to discuss how pre-owned assets may affect you please don't hesitate to contact us on 0141 848 7474 or by email at [mail@johnmtaylor.co.uk](mailto:mail@johnmtaylor.co.uk)*