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## The Pre-owned assets Charge



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With effect from 6 April 2005 Schedule 15 Finance Act 2004 introduced an **income tax** charge on UK resident individuals who enjoy benefits derived from what is now described as 'property previously enjoyed' (**land, chattels or intangible assets**), unless:

- a) the property (or other property that derives its value from the relevant property) is already included in the estate of the individual for inheritance tax purposes or
- b) the property is deemed included in the estate of the individual for inheritance tax purposes because of being a gift subject to a reservation of interest (or one that would be but for certain specific let-outs)

*[except, in both cases, that, from 5 December 2005 this does not include certain property in which the individual has an interest in possession, even though it is deemed part of that individual's estate – see later, under **Exemptions**]; or*

- c) the individual **elects** to treat the property as potentially chargeable to inheritance tax on his or her death or, if the individual has a beneficial interest in possession, to deny the reversion to settlor exemption, if applicable.

In fact, despite the now common description of this legislation as relating to 'pre-owned assets', there is no requirement that there be a 'pre-owned asset', and use of the expression can lead to a misunderstanding of the reach of Schedule 15 FA 2004.

In defence of these provisions, the then Paymaster-General, Dawn Primarolo, said –

*"We are concerned specifically with the range of schemes that allow wealthy taxpayers to give their assets away, or achieve the appearance of doing so, and so benefit from the inheritance tax exemption for lifetime gifts, while in reality retaining continuing enjoyment of and access to those assets, much as before."*

Many have protested at the perceived retrospective effect of the proposals. But the Parliamentary Joint Committee On Human Rights concluded that they *"cannot strictly be said to be retrospective; [the Schedule] imposes a prospective liability from the tax year 2005-06 in respect of the value of benefits received during those years."* Remarkably, having reached that conclusion, they went on to say *"However, we are concerned about the human rights implications of the spouse exemption. Confining the benefit of the exemption to the parties to a lawful marriage excludes from the scope of that exemption homosexual couples who live together as de facto spouses (but are legally unable to marry), heterosexual unmarried couples who live together as de facto spouses and people sharing a home on the basis of a long-term or family relationship which is not a sexual relationship."*

See [www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm](http://www.publications.parliament.uk/pa/jt200304/jtselect/jtrights/93/9305.htm)

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In fact, from 5 December 2005, under regulations made under S.103 FA 2005, 'civil partners' – those whose relationship is registered under the Civil Partnership Act 2004 (or, having registered an overseas relationship, are treated as having formed a civil partnership under that Act) - will generally be treated the same as man and wife for tax purposes. There appear to be no proposals recognising the plight of '*heterosexual unmarried couples who live together as de facto spouses* and as to '*people sharing a home on the basis of a long-term or family relationship which is not a sexual relationship*', the ECJ's rejection of the Burden sisters appeal is not encouraging.

The provisions are described in more detail below. Unless otherwise indicated all statute references are to paragraphs of Schedule 15 Finance Act 2004 or the regulations made thereunder, which are The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005 – SI.2005/724, The Inheritance Tax (Double Charges Relief) Regulations 2005 - SI.2005/3441 and The Income Tax (Benefits Received by Former Owner of Property) (Election for Inheritance Tax Treatment) Regulations 2007 - SI.2007/3000.

### Land and Chattels

- An income tax charge applies from **6 April 2005** to an individual who occupies land (which, of course, includes buildings) or is in the possession of (or has the use of) a chattel for the whole or part of a tax year *whether alone or together with other persons* and either a '**disposal condition**' or a '**contribution condition**' is fulfilled.
- A '**disposal condition**' is fulfilled if, after 17 March 1986 [when inheritance tax replaced capital transfer tax], the individual owned an interest in the relevant land or the relevant chattel (or other property some or all of the proceeds of which were applied by another person to acquire the interest in the land or the chattel) and, otherwise than by an '**excluded transaction**', has disposed of all or part of his interest in the relevant land or in the chattel— see *Paragraphs 3(2) and 6(2)*.
- A '**contribution condition**' is fulfilled if, after 17 March 1986, otherwise than by an '**excluded transaction**', the individual has, directly or indirectly, provided some or all of the consideration given by another person to acquire an interest in the relevant land or in the chattel, or property the proceeds of which have been used to acquire the interest in the relevant land or in the chattel – see *Paragraph 3(3) and 6(3)*.

### Calculating the charge

The first element of the calculation of the charge in respect of **land** is the '**rental value**', or '**appropriate amount**' for a chattel, for the '**taxable period**' – see *Paragraph 4(1)*.

The '**rental value**' for **land** is the proportion, according to the length of the 'taxable period', of the annual rent that might be reasonably expected to be payable for the taxable period on a letting from year to year where the landlord bore the cost of repairs and insurance – see *Paragraphs 4(3) and 5*.

In respect of a **chattel** the first element of the calculation (the '**appropriate amount**') is an amount equal to the interest that would be payable for the 'taxable period' at the 'official rate' adopted for employees' beneficial loans on its value at the '**valuation date**', 5% p.a. in 2005/06 and 2006/07, 6.25% p.a. from 6 April 2007, 4.75% p.a. from 1 March 2009, 4% from 6 April 2010. – see *Paragraph 7(1)*.

The '**taxable period**' is the year of assessment, or part of a year of assessment, during which the chargeable person occupies the land or is in the possession of (or has the use of) the chattel - see *Paragraphs 4(5) and 7(4)*.

The **amount chargeable** is

(a) the figure thus found multiplied by **DV/V** where-

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**DV** is the value at the '**valuation date**' of the interest in the land or the chattel originally disposed of by the chargeable individual (modified if the disposal was a **non-exempt sale**) or, where the 'contribution requirement' is relevant, such part of the value of the relevant land at the valuation date as can reasonably be attributed to the consideration provided by him; and

**V** is the value at the 'valuation date' of the relevant land or chattel – see *Paragraph 4(2)*;

less

(b) rent paid to the owner of the relevant land or chattel in respect of the occupation of the land or the possession or use of the chattel.

To be deductible, such rental payments must be made 'in pursuance of a legal obligation ... *during* the [taxable] period' – see *Paragraphs 4(1) and 7(1)*. At Committee Stage of the Finance Bill 2004 the Paymaster General, rather surprisingly, maintained that a legal obligation was essential, in order to avoid any risk that the recipient of such a payment might successfully claim not to be taxable on it. She said 'The schedule says that the deduction is available only when the payments are made under a legal obligation. Put bluntly, that requirement is intended to stop any manipulation and ensure that there is reasonable symmetry between the tax positions of the two parties. If something reduces the taxable benefits in the hands of the payer, it should clearly be taxable in the hands of the payee as rent.' She was not challenged on the awkward requirement for payment to be made *within* the chargeable period if it is to be counted.

It is assumed that, if there is a legal obligation to pay rent, payments for the benefit of the owner would be counted, such as payments to the owner's agent or payments to meet liabilities incurred by the owner or to meet liabilities incurred by the occupier on behalf of the owner. These are not strictly within the wording, but might be conceded extra statutorily.

For example, if the original disposal in 1993 was the grant for no consideration of a reversionary lease, the income tax charge – assuming no rent is paid for the occupation of the property – would be on the rental value as defined multiplied by  $DV/V$ , where  $DV$  is the value of that reversionary lease on the valuation date and  $V$  is the value then of the unencumbered freehold. Seemingly, paradoxically, even though the chargeable person is entitled to occupy by virtue of retaining the freehold, any rent payable to avoid a pre-owned asset charge would have to be due to the reversionary lessee.

HMRC had initially said that a reversionary lease granted after 8 March 1999 was inevitably a gift subject to a reservation, so no pre-owned asset charge could apply. However, in a change made to their published guidance on 29 January 2007, they admitted that, where the freehold interest had been acquired more than 7 years before the gift constituted by the grant of the reversionary lease, there was no reservation of benefit, so a pre-owned asset charge *would* arise.

The calculation of  $DV$  is modified where the earlier disposal was a '**non-exempt sale**'. This is a sale of the individual's *whole* interest in the land or chattel for a consideration paid in money in sterling or other currency – see *Paragraphs 4(4) and 7(3)*. The modification is a reduction according to the proportion the cash sale proceeds of the 'non-exempt sale' bears to the market value of the individual's interest in the land or chattel at the time of that sale.

Note that this is of no benefit where the sale is not of the individual's whole interest **or** where the disposal is not for a consideration in money, for example an exchange of properties or in some other non-cash form, such as securities.

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The rental value or appropriate amount may be reduced if the estate of the 'pre-owner' for inheritance tax purposes includes, or is deemed to include for inheritance tax purposes, an interest in the relevant property or property which derives its value from the relevant property - see **Exemptions**, later.

As to occupation of land and possession and use of chattels, Paragraph 4.6 of the HMRC **Guidance** says –

### Land

In this context 'occupation' is construed quite widely. For example, the chargeable person would be regarded as in occupation not only if they were resident in the relevant property but also if they used it for storage or had sole possession of the means of access and used the property from time to time. The chargeable person would not be regarded as occupying a property from which they receive rental payments from the person(s) actually in occupation.

If the person's occupation or use of the property is only very limited in its nature or duration it may not come within the provisions of paragraph 3. Each case will ultimately be decided on the facts and circumstances relating to it. However, in line with the Revenue's Interpretation of inheritance tax and gifts with reservation – RI 55 (November 1993) – some examples can be given of **limited** occupation that will not bring the chargeable person within paragraph 3. These include

- a house which is the owner's residence but where the chargeable person subsequently stays with the other person for less than one month each year or, in their absence, stays for not more than two weeks each year,
- social visits, excluding overnight stays by the chargeable person as a guest of the owner. The extent of the social visits should be no greater than the visits that may be otherwise be expected if the chargeable person had never previously owned the property, or made a contribution to its acquisition,
- a temporary stay for some short term purpose, for example, while the chargeable person convalesces after medical treatment, or they look after the owner while they are convalescing, or while the chargeable person's own home is being redecorated,
- visits to a house for domestic reasons, for example baby-sitting by the chargeable person for the owner's children,
- a house together with a library of books which the chargeable person visits less than five times in any year to consult or borrow a book,
- land which the chargeable person uses to walk their dogs or for horse riding provided this does not restrict the owner's use of the land.

**More significant** use of the property may bring the chargeable person within the scope of paragraph 3. Examples are

- a house in which the chargeable person stays most weekends or for more than a month each year,
- a second home or holiday home which the chargeable person and the owner both then use on an occasional basis,
- a house with a library in which the chargeable person continues to keep their own books, or which they use on a regular basis, for example because it is necessary for their work.

### Chattels

Similar considerations apply to the possession or use of previously owned chattels when the application of paragraph 6 is contemplated. Very limited or occasional use of the chattel in question will not incur an income tax charge under this schedule.

For example, a car used to give occasional lifts (i.e. less than three times a month) to the chargeable person will not be liable to the charge. But if the chargeable person is taken to work every day in the car it is likely an income tax charge will be incurred.'

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### Valuation date - see Paragraph 7

The Regulations [SI.2005/724] provide that the 'valuation date' is 6 April in the relevant tax year or, if later, the earliest time in the tax year when a charge under Sch.15 applies. If a measure of exemption [see later] applies because the estate of the 'pre-owner' includes an interest in the relevant property or property which derives its value from the relevant property, the legislation is silent as regards the valuation date to be adopted for *that* interest.

The Regulations provide, broadly, that **land and chattels** will be valued every five years.

A valuation will be made as prescribed in the primary legislation for the first taxable period in which a benefit from a particular asset becomes chargeable under Sch.15. That valuation and the rental value of land for that first taxable period will also be used in any of the four succeeding years in which a charge arises in respect of that asset. If a charge arises in the fifth year after the first chargeable year, a fresh valuation will be made which will apply in the next four succeeding years, and so on. If no charge arises for the fifth year, no valuation need be made until the next tax year (if any) for which a charge arises, and a fresh series of five-yearly valuations will start from that year. There will not be any indexation.

HMRC have advised that, where the relevant property is sold during that period and replaced by another, a new valuation should be made, and a fresh five-year cycle begins.

### Intangibles

Under paragraph 8 an income tax charge will also arise where an individual is subject to income tax under the 'settlor-interested' provision (S.624 ITTOIA 2005, formerly S.660A ICTA 1988) on income arising under a settlement the property in which includes intangible property which is, or represents, property which the individual has added after 17 March 1986, save where S.624 applies *only* because the individual's spouse or civil partner may benefit – see *Paragraph 11(2)*.

The amount chargeable to income tax where Paragraph 8 applies (the '**chargeable amount**') is equal to the interest that would be payable for the '**taxable period**' at the '**official rate**' adopted for employees' beneficial loans [5% p.a. in 2005/06 and 2006/07, 6.25% p.a. from 6 April 2007, 4.75% p.a. from 1 March 2009, 4% from 6 April 2010] on the value at the '**valuation date**' of the intangible assets within the settled property added by the chargeable individual (or which represent property added by the chargeable individual), *less* any income tax or capital gains tax payable by the chargeable individual in respect of the taxable period under S.461 ITTOIA 2005, S.624 ITTOIA 2005, Ss.720-730 ITA 2007 (previously S.739 ICTA 1988), S.77 TCGA 1992 or S.86 TCGA 1992 which is attributable to the relevant property – see *Paragraph 9*.

The chargeable amount may be reduced if the estate of the 'pre-owner' for inheritance tax purposes includes, or is deemed to include for inheritance tax purposes, an interest in the relevant property or property which derives its value from the relevant property, but with a value which is substantially less than the value of the relevant property – see **Exemptions**, later.

As with land and chattels, the '**taxable period**' is the tax year or part of a tax year during which a charge under Paragraph 8 applies. The '**valuation date**' is 6 April in the relevant tax year or, if later, the earliest time in the tax year when Paragraph 8 applies.

The '**taxable period**' is the period during which there is both intangible property in the trust and it is 'settlor-interested'. Thus, once funds in a settlor-interested trust have been completely expended in purchasing land, for example, the taxable period ends. But if such a trust has started the tax year with £1m in the bank and has spent £990,000 in May in purchasing land, so it is left with only £10,000 in the bank, the pre-owned asset charge on intangibles will be on £1m for

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the whole tax year, subject to any relief for a duplicated charge under Paragraph 18 – see later. However, for Paragraph 18 relief to apply, the initial £1m intangible property must be said to derive its value from the land, which is of course not so in these circumstances.

***Intangible assets have to be valued each year.***

STEP & CIOT in their dialogue with HMRC on this regime asked how the charge would be computed when the settled property comprised a deposit account but there was also an overdrawn current account at 6 April in the relevant year. HMRC's response was that the net value of the trust fund should be adopted, presumably because the charge is based on property which is or represents property which the chargeable person settled, which can only mean what is left. The question will be which liabilities should be deducted from gross intangibles, if there are assets other than intangibles within the settled property.

The definition of 'settlement' applicable is that in S.43 IHTA 1984, not the much wider definition relevant to S.624 ITTOIA 2005 in S.620. Thus, '**settlement**' means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being—

- (a) held in trust for persons in succession or for any person subject to a contingency;
- (b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income;
- (c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period

or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the United Kingdom; or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened.

The charge would apply to intangible assets representing property settled before 20 June 2003 as well as on or after that date (from which date S.102(5A) FA 1986, inserted by S.185 FA 2003, changed the law on property subject to a reservation of interest), even if the settlor's spouse (or, now, the settlor's civil partner) has an interest in possession, if the settlor is within the class of beneficiaries who may benefit subsequently [as in *IRC v. Eversden*].

This seems inconsistent with the description of excluded transactions in the context of land and chattels.

### Non-Resident – see Paragraph 12(1)

The charge under Sch.15 '*does not apply in relation to any person for any year of assessment during which he is not resident in the UK*'. It is assumed that this is the same as being accepted as non-resident for a tax year, and the concessionary splitting of tax years may apply. But perhaps non-residence throughout the year is required.

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### Non-Domiciled – see Paragraph 12(2) - (4)

The charge under Sch.15 will not apply to UK resident individuals who are neither domiciled in the UK nor deemed domiciled for the purposes of inheritance tax, unless the property referred to is situated in the UK. As yet, despite the changes in the taxation of the non-domiciled in the Finance Act 2008, it does not matter that the individual's income and gains may not be taxed on the remittance basis.

Furthermore, in the case of an individual who has at any time been domiciled outside the UK, no regard is to be had to settled property that is excluded property in relation to him under S.48(3)(a) IHTA 1984 [which would be because he was not domiciled in the UK when the settlement was made]. It has been suggested that the effect of these words is to prevent such property being taken into account when considering whether the exemption applies – see below under exemptions. But in fact it echoes the position for inheritance tax, whereby a subsequent change in the settlor's domicile does not affect the status of the settled property.

Paragraph 12(2) actually says '*where in any year of assessment a person is resident in the UK but is domiciled outside the UK, this Schedule does not apply to him unless the property is situated in the UK*'. This could either mean that Sch.15 applies unless the person is not domiciled throughout the tax year or that it does not apply if he is not domiciled at *any* time in the tax year.

'Note that certain property not situated outside the UK is treated as excluded property for inheritance tax purposes under S.6 or S.48 IHTA 1984; but is presumably still potentially exposed to the pre-owned asset regime.'

Note that the charge relates to values at a 'valuation date'; and therefore presumably has regard to the situs of the property on that date, as well as its nature; which is clearly of significance to a non-domiciliary.

### Excluded Transactions – see Paragraph 10

#### 'Arm's length' sales

For the purposes of the 'disposal condition' the disposal of any property is excluded if the pre-owner's disposal of the whole of his interest in the property is in a transaction made at arm's length with a person not connected with the him or 'by a transaction such as might be expected to be made at arm's length between persons not connected with each other' – see Paragraph 10(1)(a).

The definition of a 'connected person' is wider than that in S.993 ITA 2007, formerly S.839 ICTA 1988, so that a 'relative' includes uncle, aunt, nephew and niece, as well as brother, sister, ancestor and lineal descendant.

For these purposes the freehold reversion remaining after carving out a lease is a separate asset, so that its sale at full market value is an excluded transaction. This is to be distinguished from the 'shearing' operation, or Ingram scheme, which involved the *gift* of the freehold reversion.

The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations [SI.2005/724] add a further 'exemption' [although it is technically an excluded transaction]. The Paymaster-General on 7 March 2005 spoke of extending the existing exemption "*to all sales done at arm's length where they involve the whole or a part of the vendor's interest in their asset. They will extend this exemption to any part sale, even if not at arm's length, so long as it was made before 7 March 2005 and on arm's length terms. This is intended to ensure that commercial equity release schemes are not caught, nor certain 'intra-family' disposals such as where a child moves in to care for an aged parent and acquires an*

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*equitable interest in their shared home. And this will also apply to future disposals if they are made for a consideration other than money or readily realisable assets.”*

In fact the Regulations made on 16 March 2005 do not quite follow the Ministerial Statement. They say that paragraphs 3 and 6 (which impose the charge for the use etc of land and chattels) do not apply to a person in relation to a disposal of **part** of an interest in any property if –

- a) the disposal was by a transaction made at arm's length with a person not connected with him; [or]
- b) 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, and
  - (i) the disposal was for a consideration not in money or in the form of readily convertible assets [defined as in S.702 ITEPA 2003], or
  - (ii) the disposal was before 7 March 2005.

**Disposals to spouse or civil partner** - For the purposes of the 'disposal condition', a charge is excluded where the previous disposal was -

- a) a transfer to the person's spouse or civil partner (or, but only where it has been ordered by a court, a transfer to a former spouse or civil partner); or
- b) a disposal by way of gift (or, where it is for the benefit of a former spouse or civil partner, where it has been ordered by a court) by virtue of which the property became settled property in which the transferor's spouse, civil partner, former spouse or former civil partner is entitled to an interest in possession, provided that the interest in possession has not come to an end other than by the death of the spouse, civil partner, former spouse or former civil partner – see *Paragraph 1(1)(c) and (d)*.

Note that at first sight this would deny the exclusion if the interest in possession of the spouse, civil partner, former spouse or former civil partner is enlarged to give him or her absolute entitlement. This is surely illogical. And indeed the current version of HMRC's Guidance says that in such circumstances 'we would accept that the benefit of the exclusion is not lost'. This might be on the basis that the trustees' transfer is itself within the exclusion because it is to the settlor's spouse, presumably provided that he or she *is* still the settlor's spouse.

The domicile of the transferee spouse or civil partner is irrelevant.

At first glance, a charge would arise where the 'pre-owner' has *since* married (or entered into a civil partnership with) the recipient of an earlier gift of an asset (if he occupies/uses the asset or one that replaces it), which differs from the position as described on Budget Day 2004, which excluded the provision by reference to the *current* status of the spouse. But in fact the 'pre-owned asset' charge would not apply, because this would be a gift subject to a reservation, and caught by S.102 FA 1986. It *would* apply if the 'pre-marital' gift had been a cash gift that fulfilled the 'contribution condition', subject to the excluded transactions mentioned below.

**Gifts representing family maintenance, covered by the annual exemption or small gifts exemption** - For the purposes of the 'disposal condition', disposals covered by the first three of these exemptions are excluded – in the case of the second and third only if they are outright gifts to individuals. But, possibly by oversight (although admittedly they would rarely be relevant to any possible charge under Sch.15), exempt gifts in consideration of marriage (or civil

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partnership) are **not** excluded, nor are gifts out of income which are exempt because they form part of the normal expenditure of the donor and leave him with sufficient income to maintain his or her usual standard of living.

### Contribution Condition

As with those relevant to the 'disposal condition', the excluded transactions for the 'contribution condition' are the provision of consideration for the property's acquisition by or (by becoming settled property) for a spouse, civil partner, former spouse or former civil partner or representing family maintenance; and an outright gift of money covered by the annual exemption or small gifts exemption [again omitting exempt gifts in consideration of marriage or civil partnership and exempt gifts out of income].

A further exclusion applies where the acquisition was financed by an outright gift of money by the chargeable person to the other person more than seven years before the 'pre-owner' first occupied the land or had the possession or use of the chattel – see *Paragraph 10(2)(c)*.

This was in response to the observation that it was unreasonable to expect taxpayers to trace the destination of cash gifts made over a period of nearly 20 years in order to determine whether the current owner's acquisition of the land or chattels was financed to any extent by him.

Thus, on 18 May 2004, at Committee Stage of the Finance Bill 2004, the Paymaster General, at Column 262, referred to "a provision to ensure that the charge will not apply to gifts if seven years have elapsed without the donor enjoying the benefit". Arguably, as drafted, this does not actually reflect the Government's intention, because it refers to first occupation, possession or use, without reference to the terms of such occupation or possession. An occupier who pays full market rent cannot be said to enjoy a benefit, yet this would be 'occupation'. Furthermore the provision does not refer to a gift made more than seven years before a charge could arise under the 'pre-owned asset' legislation. It refers to 'more than seven years before the earliest date on which the chargeable person met the condition in Paragraph 3(1)(a) or, as the case may be, 6(1)(a)'. That condition is fulfilled by merely occupying land or being in possession of or having the use of a chattel, unless covered by an exemption under Paragraph 11. Thus it appeared from the legislation that there was no cut-off seven years before the legislation began to bite, at 5 April 1998. But HMRC has since advised, they say 'confirmed', that outright gifts of cash before 6 April 1998 (or seven years before a charge would otherwise apply) can be ignored.

Note that HMRC doubt if this exclusion would apply to cash settled in trust for the other person. So a contribution financed by cash settled in an accumulation and maintenance trust as long ago as 18 March 1986 could result in a 'pre-owned asset' charge.

### Loans

On the face of it, a loan to enable an acquisition would fulfil the contribution condition, even if on arm's length terms. Certainly, HMRC initially regarded a loan as constituting a contribution, and obviously not 'an outright gift of money', so with no seven-year limitation. Indeed the Tax Return Guide accompanying the 2006 Tax Return emphasised this (saying at page 19 'if you gave cash which directly or indirectly funded the acquisition of the property you benefit from now, but the gift was made before 6 April 1998. Cash loans made before this date are caught, however').

As the exclusion in Paragraph 10(2)(c) refers only to an outright gift of money more than 7 years before, a loan made at any time after 17 March 1986 seemed to be relevant, whether or not the loan has been repaid. The loan, if still owed, is not 'property which derives its value from the relevant property' (the requirement for an exemption under Paragraph 11).

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However, HMRC's guidance as updated on 30 May 2006, now says - 'HMRC do not regard the contribution condition set out in Schedule 15, Paragraph 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 [and therefore not reasonably attributable to the consideration (Sch 15, Paragraph 4(2)(c)], even where the loan was interest free. It follows that the 'lender', in such an arrangement, would not be caught by a charge under Schedule 15.' Unless this is to be confined to cases where the loan is still outstanding, which would surely be illogical, it seems to exclude all contributions by way of loan.

### Guarantees

A guarantee in respect of a loan to another person by a third party in connection with the borrower's acquisition of any property is not treated as provision of consideration for its acquisition – see *Paragraph 17*.

### Deeds of Variation

A disposition by a 'pre-owner' which affects the dispositions of a deceased person's estate by virtue of any of Ss.142-147 IHTA 1984 is disregarded for the purposes of these provisions if it is not treated as a transfer of value by the individual – see *Paragraph 16*.

### Exemptions

#### Property in the individual's estate

The Finance Act 2004 'dis-applies' the Sch.15 charge where the individual's estate for inheritance tax purposes includes the relevant property (land, chattel or settled property) or other property that derives its value from the relevant property whose value is not substantially less than the value of the relevant property. The 'relevant property' in the case of land and chattels is the property disposed of (where the disposal condition is relevant) or the property representing the consideration provided (where the contribution condition is relevant). In the case of intangibles it is the chargeable property under Paragraph 8 – Paragraph 11(9).

If the value of the property in the individual's estate is substantially less than the value of the relevant property, the rental value etc is to be reduced to take account of the extent that the relevant property or 'derived' property is in the individual's estate.

HMRC's Technical Guidance says 'The term 'substantially less' is not defined by the legislation but by analogy with the Capital Gains Tax taper relief rules we would regard a reduction of value of less than 20% as not substantially less for the purposes of this Schedule. If the circumstances of a particular case suggest that the "substantially less" provision should be triggered by a reduction of more or less than 20%, it will be judged on its individual merits.'

Paragraph 11(1) actually says 'Paragraph 3 (land), paragraph 6 (chattels) and paragraph 8 (intangible property) do not apply to a person at a time when his estate for the purposes of IHTA 1984 includes the relevant property, etc.' For paragraph 8 (the charge on intangible settled property), this therefore, reasonably enough, before the change from 5 December 2005 referred to later, exempted the settlor with an interest in possession in the settled property (where the settled property was treated as part of his estate). But the exemption does not cover the situation where the intangible property, is included in the estate of the spouse of the 'pre-owner' for the purposes of IHTA 1984.

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In the case of intangible property in a settlement in which the settlor has a reversionary interest, such an interest *is* within the settlor's estate for inheritance tax purposes (S.48(1)(b) IHTA 1984) and derives its value from the property in the settlement; so there would be a measure of exemption, dependent on the value of the reversionary interest compared with that of the settled property.

The reference to property that derives its value from the relevant property is particularly relevant where property is owned by a company whose shares are owned by the occupier.

Thus UK homes might be owned by offshore companies the shares in which are owned by non-domiciliaries, perhaps through an offshore trust, or holiday property in Spain might be held through a Gibraltar company by UK resident domiciliaries.

So there may be no charge under Sch.15 FA 2004 where the property is owned by a single-purpose company all the shares of which are owned by the occupier of the property, or owned by a trust in which the settlor has the interest in possession.

This assumes that the value of the shares and any loan made by the 'pre-owner' to the company equates roughly with the value of the underlying property. But HMRC do not regard a loan made to the company by the chargeable person as deriving its value from the underlying property; 'unless (possibly) the loan is charged on the house'.

But for Paragraph 11(6), this provision might have resulted in the survival of the 'twin-trust' scheme – which is one of the targets of the legislation. But subparagraph (6) introduces the concept of excluded liabilities. That is a liability the creation of which is associated with any transaction by which the individual's estate came to include the relevant property or any property deriving its value therefrom.

Thus, where the value of any property is reduced by any such liability of the 'pre-owner', it is not to be treated as comprised in the estate of the 'pre-owner' save to the extent that its value exceeds the 'excluded liability' – see *Paragraph 11(6) & (7)*. HMRC advise that the 'excluded liability' is the face value of the loan and any unpaid interest thereon.

### **Property subject to a reservation of interest**

The provisions do not apply where the land, chattels or intangibles are already subject to a reservation under S.102 FA 1986, and therefore still potentially subject to inheritance tax on the donor's death. Furthermore, the charge does not apply if the property would have constituted a gift subject to a reservation but for S.102(5)(d)-(i) FA 1986 [the fact that the gift was given to charity, etc], S.102B(4) FA 1986 [gift of undivided share in land where donor and donee share occupation] or S.102C(3) or Paragraph 6 Sch.20 FA 1986 [exclusion of benefit in certain circumstances – including where the charge is inapplicable because full consideration is given for any continued use or occupation]. It is notable that 'full consideration' for this purpose differs from that required to avoid a charge under the 'pre-owned assets' regime. For example, 'full consideration' would cover a lease granted at a premium or one granted at a rent which, although open market at the outset, has since become less than a rack rent.

An Inland Revenue letter of 18 May 1987 regarding gifts subject to a reservation said at paragraph 7 that '*in a case where a gift is made into trust, the retention by the settlor of a reversionary interest under the trust is not considered to constitute a reservation.*'

So a charge would arise on the settlor under Paragraph 8 in respect of intangible property in a settlement which he settled after 17 March 1986 giving his wife (either UK domiciled or having the same domicile as him) or a third party an

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interest in possession with remainder to himself, save that an exemption would be available in proportion to the value of the reversion at the relevant date compared with the value of the settled property;

### The change from 5 December 2005

With effect from 5 December 2005, as announced in the Pre-Budget Report, legislation in the 2006 Finance Bill, was to 'close a gap in the pre-owned asset income tax charge that can let through cases where an owner transfers their asset but continues to enjoy it as the beneficiary of a 'reverter-to-settlor' trust.'

The Pre-Budget Report said 'This will apply where the former owner of an asset (or a person who contributed to its acquisition) enjoys the asset under the terms of a trust, and the trust property may in due course revert to the settlor – or to the spouse or civil partner or the widow, widower or surviving civil partner of the settlor – in circumstances that are eligible for exemption.'

In fact the amendment made by FA 2006 is not confined to such cases.

S.80 FA 2006 modifies Paragraph 11 so 'where at any time the relevant property has ceased to be comprised in his [the chargeable person's] estate for the purposes of IHTA 1984 or he has directly or indirectly provided any consideration for the acquisition of the relevant property and at any *subsequent* time the relevant property or any derived property is comprised in his estate for the purposes of IHTA 1984 as a result of S.49(1) of that Act (treatment of interests in possession)', the exemption is denied to such settled property. It is not to be treated as comprised in his estate nor as subject to a reservation of interest.

### The effect of this is illustrated below

#### Example 1

In 1990 Abel gave his widowed mother Eve the cash to enable her to buy her council house. Eve died in 2005 leaving her house in trust for Abel for life with remainder to her grandson. Abel lives in the house, and of course, as life tenant, he pays no rent. Despite the house already being deemed to be part of Abel's estate for inheritance tax purposes, he would not be exempted from a pre-owned asset charge – unless the *de minimis* applied.

#### Example 2

Adam settled a holiday cottage in trust in 2000 giving his new wife (like him, domiciled in England) an interest in possession only while they are married, and himself a defeasible life interest thereafter, with remainder on discretionary trusts for his siblings and his issue. He subsequently shares occupation of the cottage with his wife. There is no pre-owned asset tax charge in respect of this occupation because the initial transaction is excluded. Then in May 2008 they divorce and Adam's wife's interest in possession ends. The initial exclusion therefore ends, but Adam's interest in possession does not provide any exemption, even though the cottage is deemed to be in Adam's estate.

#### Example 3

Pierre, non-domiciled, settles assets in trust in 1996 giving himself an interest in possession contingent on surviving a month, with remainder to his children. There are no exemptions available to prevent Pierre being exposed to a pre-owned asset charge in respect of UK-situate property.

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### Effect of the election

Suppose each of them makes an election by the appropriate deadline under Paragraph 21 or Paragraph 22, as the case may be.

As each of the chargeable persons is beneficially entitled to an interest in possession, only Paragraph 21(2)(b)(iii) or Paragraph 22(2)(b)(iii) applies. These say that, so long as the chargeable person continues to enjoy the property (or the relevant property remains in the settlement), 'if the chargeable person is beneficially entitled to an interest in possession in the property, sections 53(3) and (4) and 54 of IHTA 1984 (which deal with cases of property reverting to the settlor etc) shall not apply to the chargeable proportion of the property'.

As none of these provisions would have applied anyway, the election does not actually result in any additional inheritance tax liability. This may be seen as confining the deleterious effect of the change made by FA 2006 to its intended targets, but leaves such as those in the examples with an inappropriate income tax charge if they overlook the election.

### Assets Eligible For Business Property Relief Or Agricultural Relief

It is notable that, if assets qualifying for either of these reliefs come within Sch.15, there is *no* relevant exclusion or exemption.

### De Minimis - see Paragraph 13

There is no charge under Sch.15 where the charge for a tax year would otherwise be on an amount not exceeding £5,000 (before deducting any 'rent' paid in the case of land or chattels). If the amount exceeds £5,000, there is no relief at all.

### Duplicated Charge to Income Tax

A charge could arise under Sch.15 on land and/or chattels as well as on intangible settled property that derives its value from such land or chattels. Paragraph 18 provides that where someone is, 'apart from this paragraph', chargeable both under Paragraph 3 or 6 on land or chattels and under Paragraph 8 on intangibles [such as shares in a company owning the land or chattels], only the provision that produces the higher chargeable amount is to apply.

Because the comparison is between the amounts chargeable; the figure for land or chattels is after deduction of any 'rent' paid under a legal obligation.

The relationship between Paragraph 18 and the de minimis in Paragraph 13 could be clearer. The words of Paragraph 18 suggest that one applies the de minimis before considering the operation of Paragraph 18. But HMRC's guidance says that, having applied Paragraph 18 to see which produces the amount of tax (but the statute refers to 'the higher chargeable amount'), '*if this amount does not exceed the de minimis limit no tax will be payable – the lower amount is disregarded completely.*' But the de minimis is not expressed in terms of tax.

Suppose the rental value under Paragraph 3 is £6,000 but the taxpayer pays £4,000, to leave chargeable £2,000, while the amount chargeable under Paragraph 8 is £5,000.

Should the comparison be made before deducting rent; as it is the gross amount that is compared with the de minimis, for land and chattels? Or should the de minimis be considered before Paragraph 18. If so, on the figures quoted, the Paragraph 8 charge would be eliminated by the de minimis, so Paragraph 18 would need not be considered, leaving only the Paragraph 3 charge on £2,000 to survive.

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If the de minimis is only relevant after applying Paragraph 18, that would give £5,000 under Paragraph 8 as the higher amount chargeable, but the de minimis under Paragraph 13 would leave no tax liability.

The same individual could be chargeable to income tax on the occupation of land or possession or use of a chattel under ITEPA 2003 as a benefit in kind from employment, as well as under Sch.15. Paragraph 19 resolves this by reducing any amount otherwise chargeable under Paragraph 3 or Paragraph 6 by the amount chargeable under ITEPA.

There is, however, no reduction in the charge under Paragraph 8 on intangible property whose value reflects such land or chattels because of a charge under ITEPA. So, if Paragraph 18 has led to the charge under Paragraph 8 on intangibles prevailing, that will apply as well as any charge under ITEPA by reference to the same land or chattels.

As mentioned later, Paragraph 18 does not address the inheritance tax position if an election is made under Paragraph 21 or 22.

There is no recognition of the possibility of the individual being chargeable to income tax on occupation of land or possession or use of a chattel under S.418 ICTA 1988 as a participator in a close company as well as under this new provision.

### [Election to Disapply - see Paragraphs 20-23.](#)

The Government believed that, by deferring the introduction of this new charge until April 2005, those affected would have ample time to dismantle structures so as to avoid the income tax liability. Alternatively, as such action might often not be possible, the Finance Act 2004 provides that an individual may make an election that the Government thinks would have the same effect.

The election, under Paragraph 21 in respect of land or chattels and under Paragraph 22 in respect of intangible property, has to be made *'in the prescribed manner'* by the 31 January next following the first year the individual would, but for such election, be chargeable under Sch.15.

Originally Paragraph 23(3) said 'The election must be made on or before the relevant filing date, unless the chargeable person can show a reasonable excuse for the failure to make the election by that date' and Paragraph 23(4) said 'Where the chargeable 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.'

S.66 FA 2007 replaced these two sub-paragraphs with 'The election must be made on or before a) the relevant filing date, or b) such later date as an officer of Revenue and Customs may, in a particular case, allow.' Thus, in the initial wording the 'later date' had to be 'prescribed', necessarily by regulations, but these did not exist. That omission has been remedied by making it such later date as an officer of HMRC may allow.

However, Paragraph 23(2) says 'the election must be made in the 'prescribed manner'. Paragraph 1 defines 'prescribed' as meaning prescribed by regulations, and such regulations were still not available when the Finance Act 2007 received Royal Assent. This was finally remedied by The Income Tax (Benefits Received by Former Owner of Property) (Election for Inheritance Tax Treatment) Regulations 2007, SI 2007/3000, which were laid before Parliament on 22 October 2007 and came into force on 14 November 2007.

Except where the chargeable person is 'beneficially entitled to an interest in possession' in the relevant property, the effect of the election is that the 'chargeable proportion' of the relevant property (or property which represents or is derived

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from the relevant property) [the DC/V fraction used in determining what proportion of the annual rent, or its equivalent for chattels, is chargeable] is treated as though it represents a gift made subject to a reservation, and is therefore potentially chargeable as part of the 'pre-owner's' estate for inheritance tax purposes on death, so long as he or she continues to enjoy its use or occupation or, in the case of settled property as referred to in Paragraph 8, so long as the relevant property remains settled and the individual continues to be chargeable under S.624 ITTOIA 2005 on any income arising thereon – see *Paragraphs 21(2)(b)(i) and 22(2)(b)(i)*.

If the chargeable person is beneficially entitled to an interest in possession<sup>1</sup> in the relevant property, as illustrated earlier, the effect of the election is that S.53(3) & (4) and S.54 IHTA 1984 are not to apply in relation to the property, these being the provisions which give inheritance tax exemption to property reverting to the settlor etc – see *Paragraphs 21(2)(b)(iii) and 22(2)(b)(iii)*.

It is notable that it is the 'chargeable proportion' of the property that is treated as property subject to a reservation election under Paragraph 21(2)(b)(i) or 22(2)(b)(i). However, if the relevant property reverts to the chargeable person's ownership, as S.102(3) FA 1986 applies, it would no longer be treated as subject to a reservation to the extent that it forms part of his estate; but it would remain so treated if the property actually now in the estate of the chargeable person at his death were merely property deriving its value from the 'pre-owned' property, such as shares in a company owning the house he occupies. This seems unlikely to be intended.

In the case of settled property, the 'relevant property' (the intangibles that gave rise to the possible charge under Paragraph 8) or any property that represents or derives its value from the relevant property remains affected by the election on the death of the settlor so long as it remains settled property and he remains chargeable under S.624 on the income therefrom (and also if he were to die within 7 years of it ceasing to be settled in that manner).

Furthermore, it would continue to be potentially chargeable to inheritance tax if, although the settlor ceases to be a potential beneficiary, his *spouse* continues to be a beneficiary; whereas, if – at the outset – S. 624 only applied because the settlor's spouse was a beneficiary, Paragraph 8 would not apply at all. Strangely, although one would have thought this seems unlikely to be intended, HMRC agree this analysis, with no suggestion of concession.

For land and chattels, the legislation says that the relevant property remains deemed subject to a reservation so long as the individual continues to *enjoy* the relevant property, and therefore potentially subject to inheritance tax on his death. Paragraph 21(4) says 'a person enjoys property if (a) in the case of an interest in land, he occupies the land, and (b) in the case of an interest in a chattel, he is in possession of, or has the use of, the chattel. But, if the result of the election is to deem the property to be property subject to a reservation for the purposes of Part 5 of the Finance Act 1986, applying S.102(4) FA 1986, but the person subsequently gives 'full consideration' for his occupation, the consequent cessation of the deemed gift subject to a reservation is treated as a potentially exempt transfer and inheritance tax will only arise if he dies within 7 years of commencing to give full consideration.

Paragraph 23(5) permits an election to be withdrawn or amended during the life of the chargeable person on or before the 31 January next following the first year that the individual is chargeable under Sch.15. For those affected by Sch.15 from its commencement this meant 31 January 2007, subject to HMRC accepting a late election, although the guidance on acceptable circumstances was not very promising. In their April 2007 IHT Newsletter, HMRC said that this measure was aimed at people who may have been unaware that they were liable to the POA charge. HMRC said 'Provided they elect into IHT as soon as practical after discovering they were liable to the POA charge, we will normally be able to accept a late election.'

<sup>1</sup> This phrase is not defined, but appears in S.49(1) IHTA 1984

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There is no provision for a deferral of the date by which an election may be withdrawn. But, in view of the delay in prescribing the form of election, so that arguably an election could not have been made legitimately before 14 November 2007, there is room for a contention that any election made before that date was invalid, and lapses. There may be cases where an unexpected death makes such a contention worth pursuing.

### Duplicated Charge To Inheritance Tax

There are circumstances where inheritance tax would arise on the death of the 'pre-owner' both as a result of an election to disapply the charge under Sch.15 and on the original disposition in consequence of his death within seven years thereof. The Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005 SI. 2005/724 addressed this, but only give relief where the original disposition was settling in trust '*property representing the proceeds of the disposal of relevant property*'.

This was, however, followed by The Inheritance Tax (Double Charges Relief) Regulations 2005 - SI.2005/3441, which provide relief where a person has made a gift of a debt owed to him or her which becomes chargeable to inheritance tax as a consequence of death within seven years, where the debt represented consideration for the purchase of an asset owned by the donor, or to provide funds for such a purchase, and the full value of that asset, or of property deriving its value from it, is also chargeable to inheritance tax as part of the donor's estate at death.

The effect of these provisions is to retain the higher inheritance tax liability, reducing the other to nil.

But there are situations where an inheritance tax charge on the individual's death could arise as a result of elections made under both Paragraph 21 and 22 with respect to relevant property and property whose value is derived therefrom.

Paragraph 18 provides that an individual cannot have an income tax liability in the same year with respect to land or chattels and intangible property which derives its value therefrom. But, once an election is made under either Paragraph 21 or Paragraph 22, the conflict seems to disappear. Thus, the individual would have to make an election under both Paragraph 21 and Paragraph 22 to avoid an income tax charge. There is a possible argument that, having applied Paragraph 18 to determine the higher chargeable amount for a particular year, the lesser amount is not 'revived' by an election as regards the greater *for that year*. But, if the same circumstances exist in the following year, a second election would be needed to avoid a charge. If that is so, avoiding both income tax charges results in a double exposure to potential inheritance tax liability.

### Link With Inheritance Tax Saving

There is no reference to, nor is there any relationship with, the inheritance tax potentially avoided by the action under attack. The estate of a 'pre-owner' unlikely to be professionally advised could be such that there would be little or no potential inheritance tax payable if the election described above were made; yet the amount annually chargeable under Sch.15 could be significant. A well-advised 'pre-owner' would be aware of the opportunity to make the election; but the very circumstances that result in there being no potential inheritance liability resultant from the election may be those in which timely advice is unlikely to be available.

### Conclusion

This legislation was long in gestation, from the first brief announcement on 17 December 2003 to the Regulations made in March and December 2005, followed by S.80 FA 2006 and S.66 FA 2007 and the regulations made in October 2007.

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The attempt to avoid a double liability to income tax is ill-drafted and inadequately explained by HMRC. The provisions designed to avoid a double charge to inheritance tax do not go far enough.

The changes to Exemptions made by the Finance Act 2006 are particularly strange and unfair in their effect if a timely election is overlooked.

No pre-owned asset charge arises if a man settles a house in trust giving his wife the interest in possession, even though he includes himself as a reversionary beneficiary. But if the settled property is, or becomes, intangible property, a charge under Paragraph 8 would arise. There seems no logic in this.

There is no pre-owned asset charge on the settlor of a settlor-interested trust if the only settled property is a farm; but if the farm business is incorporated, there is a charge under Paragraph 8 by reference to the shares in that company. This too seems illogical.

The 2006 Tax Return made no overt reference to 'pre-owned assets', and left the reader to recognise that 'any other taxable income' could include an amount chargeable under Sch.15 FA 2004. It seems unlikely that many of those affected will have recognised their position. The fact that the 2006 Tax Return Guide SA150 did not reflect HMRC's U-turn on the subject of loans is another cause for concern.

Subsequent tax returns do at least refer to a 'benefit arising from a pre-owned asset', although the relevant explanations in the 2007, 2008 2009 and 2010 Tax Return Guides are almost verbatim copies of that for 2006, omitting a reference to loans but still providing inadequate and arguably positively misleading advice and explanation.

For example, there is no reference to the inter-spouse exclusions nor the deductibility of what rent *is* paid for land or chattels, the Tax Return Guides for 2007 and 2008 refer to cash gifts made before 6 April 1998 being excluded, rather than those made more than 7 years before the first benefit arises and none of the Tax Return Guides mentions the deductibility of capital gains tax chargeable on the settlement's gains if the benefit relates to intangibles in that settlement

Finally, it continues to be implied in all the Tax Return Guides, that having an interest in possession always affords an exemption.

On that point the 'Guidance' to which to which one is directed by the Tax Return Guides [See [http://www.hmrc.gov.uk/poa/poa\\_guidance.htm](http://www.hmrc.gov.uk/poa/poa_guidance.htm)] admits [in February 2009] that 'The guidance notes reflect the current law and do not take account of any proposals contained in the 2006 Finance Bill. As soon as any changes proposed by the bill become law we will review the guidance to see if, and to what extent, amendments need to be made.' It seems unlikely that HMRC really think that 'the 'proposals contained in the 2006 Finance Bill', which became law in 2006, are insufficient to warrant any change to their guidance.

In fact, the guidance notes, as presently available, actually say 'Legislation introduced in the 2006 Finance Bill will, from the 5th December 2005, prevent property gifted by the donor but still enjoyed by him as a beneficiary of a reverter-to-settlor trust from escaping an income tax charge under Schedule 15. The new legislation will allow a Schedule 15 charge to apply in situations where the former owner of an asset (or a person who contributed to its acquisition) enjoys the asset under the terms of a trust, and the trust property reverts to the settlor – or to the spouse or civil partner, widow, widower or surviving civil partner of the settlor.'

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However, as mentioned earlier, the 'new legislation' actually goes further than that – by denying an individual exemption if it otherwise depends on him having an interest in possession in the relevant property (in circumstances where the property is deemed to be in his estate) if he was the settlor, unless he has always had that interest.

Matters are not improved by the design of the form [IHT500] that HMRC have previously said should be used when making an election under Paragraphs 21 or 22, nor by the form now prescribed by regulations, for use from 14 November 2007, which only refers to 'property you have previously owned' - see <http://search2.hmrc.gov.uk/kbroker/hmrc/forms/viewform.jsp?formId=3374>

There is clearly much more to be done if HMRC are to be able to claim that they have adequately explained this legislation to their 'customers'.

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