EXPLANATORY MEMORANDUM TO THE CHARGE TO INCOME TAX BY REFERENCE TO ENJOYMENT OF PROPERTY PREVIOUSLY OWNED REGULATIONS 2005

2005 No. 724

1. This explanatory memorandum has been prepared by the Commissioners of Inland Revenue and is laid before the House of Commons by Command of Her Majesty.

   This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 As announced in the Paymaster General's written statements of 7 & 8 March 2005, these Regulations reflect the responses to the Inland Revenue's consultative document of 18 August 2004 ("Taxation of Pre-Owned Assets: Further Consultation"). They cover the following five areas:

- first, they set the operative date for valuations at 6 April in the year, or if later, the beginning of the taxable period in which the asset in question first becomes chargeable to income tax;

- second, they set the prescribed rate (to be applied to the capital value of chattels and intangible assets when quantifying the cash value of the benefit enjoyed) as equal to the official rate of interest, as defined in section 181 of the Income Tax (Earnings and Pensions) Act 2003. The rate is currently 5 per cent;

- third, they provide for valuations at extended intervals, broadly every five years, in the case of land and chattels. The valuation made when an asset first becomes chargeable will also be used in any of the four succeeding years in which a charge arises. 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 or any later five-year anniversary year, no valuation need be made until the next tax year (if any) for which an income tax charge arises, and a fresh series of five-yearly valuations will start from that year. Valuations will be carried forward in cash terms without adjustment (i.e. there will be no indexation for asset price changes, as the enabling power would permit);

- fourth, they extend an existing exemption for cases where the owner of an asset sells his interest in an asset and continues to enjoy it. This currently only applies where the whole interest is sold: the regulations extend it to certain sales of a part interest. It will apply to any such sale when done at arm's length, and to sales which are not arm's length if they are on arm's length terms and either done before 7 March 2005 or done on or after that

date and for consideration not in the form of money or an asset readily convertible into money;

- finally, they give relief in certain circumstances from a potential double inheritance tax (IHT) charge. This can apply where the former owner of an asset disposes of it in circumstances such that Schedule 15 applies, and gifts the disposal proceeds (commonly an IOU) into a trust. If the former owner makes an election in accordance with paragraph 21 of Schedule 15, and dies within seven years of the gift into settlement, the value of the gift into trust will be aggregated with their estate at death for IHT purposes, and the value of the asset disposed of will also be treated as part of their estate by virtue of the election. The regulations provide relief so that, broadly, tax is due only on one of these components, whichever gives the larger tax liability.

3. Matters of special interest to the Joint Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 Schedule 15, Finance Act 2004 provides for income tax to be charged - starting on 6 April 2005 - on the benefit people gain, in certain circumstances, from the continuing enjoyment of assets they formerly owned. The taxable benefit is chargeable by reference to market rentals in the case of land, and by applying imputed yield to capital values in the case of chattels and intangible assets. This amount will be treated as additional taxable income of the chargeable person, subject to a de minimis threshold of £5,000. There are numerous exclusions from the charge, for example, property which ceased to be owned before 18 March 1986, and property formerly owned which has been transferred to the former owner's spouse.

4.2 Additionally, Schedule 15 contains enabling powers allowing certain matters to be included in regulations. For example, the operative date for valuations, frequency of valuations, rates of return as well as further exemptions from the income tax charge.

4.3 The IHT rules on lifetime gifts of property were introduced in the 1986 Finance Act. As a result of those rules, a potential double IHT charge on the same asset value on the same event could arise in certain circumstances. So section 104 of that Act contains an enabling power which provides for relief to be given by means of regulations to ensure that only one IHT charge arises in these circumstances. Regulation 6 uses that enabling power to provide relief from a similar potential double IHT charge as a result of an election under paragraph 21 of Schedule 15.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Commission on Human Rights

6.1 Not applicable

7. Policy background

7.1 The Chancellor of the Exchequer announced proposals in his Pre-Budget Report on 10 December 2003 to impose a free-standing income tax charge, starting on 6 April 2005, on the benefit people enjoy from free or low-cost use of assets they formerly owned (or provided the funds to purchase); known as "Pre-Owned Assets". These proposals were prompted by the Government's determination to counter contrived schemes to avoid IHT which had been widely marketed prior to the announcement, and to discourage comparable schemes in the future. These schemes involve artificial structures by which people circumvent the IHT "gift with reservation" rules by removing assets from their taxable estates while continuing to enjoy them.

7.2 Following the Chancellor's announcement, the Inland Revenue published a consultative document on 11 December 2003 seeking views on the detailed working of the income tax charge. The Chancellor subsequently confirmed his intention to proceed with the income tax charge in his 2004 Budget. Details were set out in BN40 dated 17 March 2004, which made clear that further consultation would follow to settle the rates of yield and other operational matters.

7.3 The legislation was brought forward in the Finance Bill 2004 and is now contained in Schedule 15 of the Finance Act 2004. Schedule 15 contains a number of exclusions and exemptions from the charge that would otherwise apply, and provides for operational matters and further exemptions from the charge to be made in secondary legislation.

8. Impact

8.1 These Regulations do not impose new costs on business or charities.

9. Contact

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