Briefings

What is a failed PET and how can it be avoided?

Julie Butler looks at the often overlooked area of traps regarding potentially exempt transfers.

There are many who consider a failed PET to be a dog that disgraces itself in front of important guests. The current re-structuring of the ownership of farmland and farming business units under diversification can include gifting to the next generation. Largely this involves making a gift now under the potentially exempt transfer rules. Consideration must be given to not only capital gains tax on this gift, or potential capital gains tax, but whether there will be BPR or APR on a failed potentially exempt transfer. These situations are set out below.

What is a 'failed PET'?

A failed PET arises where the doner gifts an asset which is at the time of the gift a potentially exempt transfer, but the donor then dies within seven years of making the gift so that the PET becomes chargeable to IHT. BPR is available against the failed PET if the conditions for obtaining a relief were fulfilled at both the date of the PET and the date of the subsequent death (section 113A(1), IHTA 1984). Similar rules apply to transfers to discretionary trusts (section 113A(2), IHTA 1984).

In order for BPR to be available on the failed PET, or the recalculation of the lifetime chargeable transfer, two conditions must be satisfied:

- The property must qualify as a 'relevant business property' for BPR at the time of the death (section 113A(3)(b) IHTA 1984).
- The recipient of the lifetime gift must have retained the property given until the death of the transferor or, if earlier, his own death (section 113A(3) IHTA 1984).

The conditions are applied strictly. Although property moving between an individual and a settlement in which he or she has an interest in possession is ignored for this purpose, as for all other purposes of IHT (section 49 IHTA 1984), any other change in ownership denies the relief. Hence, a transfer of property between spouses, while an exempt transfer for IHT purposes, would cause any BPR on a PET to be removed if the donor dies within seven years.

In the same way that BPR is available on a PET that becomes chargeable by virtue of the death of the donor within seven years, APR is also available (section 124A, IHTA 1984).

One area that cannot be planned is the date of death. Carrying out tax planning around ill or very ill clients can be very sensitive. Practical work can involve a regular review of the lifetime gifts and of course warning the transferor and transferee at the point of transfer.

There are a large number of changes to the gift that can take place over the seven years and not all landowners and donors may be aware of them. The aim of this section is to highlight the fact where gifts that should qualify for BPR or APR are made it is important that any changes over the next seven years are planned for tax purposes. Let us look at these situations.

In a similar position to BPR, there is provision to cover the situation in which the agricultural property that was gifted is sold and replaced by other agricultural property that is owned at the date of death (section 124B, IHTA 1984). APR and BPR reliefs are only available where both the disposal of the original property and the acquisition of the replacement are made in a bargain at arm's length or on such terms as would be contained in such a bargain (section 124B(2), IHTA 1984). Clearly this means that disposals and subsequent purchases must be carefully monitored between family members and associates. The time limit of three years or such longer period as the Board may allow is also the same (section 124B(2)(a), (5)(b), IHTA 1984). The conditions for the relief are then applied to the original and replacement property so that the transferee must have owned the original property at the date of the disposal and the replacement as from the date of the acquisition. The properties must have been occupied for purposes of agriculture during these times and the replacement property must be agricultural property immediately before the death (section 124B(3), IHTA 1984). As with BPR, where the donee dies before the donor, the rules are applied at the death of the donee (section 124B(5), IHTA 1984).

The similar position is when business property replaces agricultural property. The donee should ideally check with their donors tax adviser before the replacement.

Where there has been a reorganisation of the share capital of a farming company, within the APR qualifications, or where the property held at the date of death consists of shares of a farming company, for which the original property was exchanged, the shares held at death are treated as if they had been the subject of the PET (section 124A(6), IHTA 1984). APR is made available by deeming the owner of the shares to be the owner of the original agricultural land.

There are provisions for BPR where the conditions as to length of occupation or ownership are not satisfied but the farm was acquired on a previous transfer that did qualify for relief. It is further necessary that it should be only these conditions that prevent relief on this occasion and that one of the transfers should be on death (section

121, IHTA 1984). Provision is made for the replacement of property between the two transfers; as with the general replacement rule, relief is restricted to the lower of the agricultural values of the replaced and present farms (section 121(2), IHTA 1984). Where, on the previous transfer, only a part of the value qualified for relief as where the earlier transfer was a part purchase, only a like part can be reduced on the present transfer (section 121(3), IHTA 1984).

In a similar position to BPR, there is a condition that the original property transferred must be owned by the transferee from the time of the transfer to the death of the transferor (or the earlier death of the transferee) (sections 124A(3)(a) & (4), IHTA 1984). Where property is settled on trusts in which there is no interest in possession, the trustees are to be treated as the transferee (section 124A(8) IHTA 1984). It is imperative that transferees keep the transferor and their tax adviser fully aware of all changes of ownership and occupation and ideally before the change.

It is essential that where the original property is agricultural property prior to the death (of the transferor or, if earlier, that of the transferee) and should have been occupied by the transferee (or another) for the purpose of agriculture throughout the relevant period (section 124A(3)(b), IHTA 1984). Care must be taken where the original property consists of shares in a farming company and so, in this instance, it will suffice that the company that owned the land and farm was occupied for the purposes of agriculture throughout the period (section 124A(3)(c) IHTA 1984). The replacement by agricultural property is mentioned above. Satisfaction of the tax rules should also be achieved by replacement with business property. BPR criteria are essential – see below.

It is important to look at a gift of a BPR property which is sold and an agricultural property purchased. If the donor then dies within seven years of making the gift, is any relief available on the failed PET? In the Inland Revenue's view, BPR is available if the agricultural property satisfies the requirements for business property (such as, it is farmland farmed by the donee) but neither relief is available if it does not satisfy the BPR criteria (such as if it is farmland let to another person) (Inland Revenue Interpretation RI95).

It is important that the tax planner reviews all gifts in the last seven years to ensure that any potential risk of the loss of BPR/APR is highlighted to the parties concerned and such rescue action as is required is taken. Once again this highlights the need for agricultural property to embrace all 'business' not 'letting' criteria.

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The UK as a personal tax haven – enjoy it while it lasts

Margaret Meechan, ACA ATII, Director, Tax Innovations and Solutions Ltd looks at the Inland Revenue's review of the residence and domicile rules.

In the international community the UK has long held a reputation as a personal tax haven for non-UK individuals. International tax planners have even marketed this; through the possibility of keeping overseas income sheltered from the UK tax net provided it is not remitted to the UK.

The Chancellor, in his recent budget, announced that there would be a review of the rules of residency and domicile with a view to reporting back in the Pre-Budget Report in November 2002. In essence this would appear to be a statement that the favourable tax rules available to non-UK individuals may cease to be so favourable.

The prompting for this statement may indeed have been the recent national press 'exposure' of the low sums of tax collected from the super-rich; but this is hardly breaking news and indeed has come under the scrutiny of previous Governments. The conclusions up until now have been to leave well alone. If for no other reason than the super-rich tend to be super-mobile and, therefore, highly likely to exit the UK leaving no tax collected from them, rather than the magnitude of sums the Treasury may wish.

The current position

The current basis of liability to UK income tax and Capital Gains Tax is 'residence' but with the subtle distinctions of whether an individual is resident, ordinarily resident or domiciled in the UK. However, as is so often the case with crucial distinctions in tax, there are no statutory definitions of these terms, rather a mixture of case law and Revenue practice. To add to the confusion for a non-UK individual these distinctions are not necessarily used elsewhere in the world.

Looking at an outline definition of the terms, they are:

Resident – a person is resident for tax purposes for the whole of the tax year if that person is physically in the country for 183 days or more in any given tax year, or present for 91 days on average per year over any four consecutive tax years.

Ordinarily resident – this is, broadly, habitual residence over a period of several years. If intent is imprecise a person will become ordinarily resident from the beginning of the tax year in which the third anniversary of arrival occurs. As with other tests, the residence position will be decided upon earlier if there is a clear decision to stay before the end of the third year.

Domicile – This is essentially an individual's permanent home and can be quite difficult to change.