PRE-OWNED ASSETS – WHAT IS THE RELEVANT LAND? THE MULTI-STOREY PROBLEM

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Most readers will be familiar with the general scheme of the pre-owned assets Income Tax charge (the 'charge') which commenced on 6 April 2005. Broadly, and subject to certain limited exemptions, the charge applies to individuals who retain a benefit from assets they have given away, in circumstances such that the Inheritance Tax gift with reservation of benefit provisions do not apply.

The pre-owned asset provisions are set out in Schedule 15 to the Finance Act 2004. There are separate rules for land, chattels and intangible property held in a settlement.

In the code for land, chargeability is based in part on occupation of 'relevant land'. There is some ambiguity, however, in the meaning of relevant land, which this article examines.

The basis of the charge

The basic conditions for chargeability are set out in the first four sub-paragraphs of paragraph 3 of schedule 15 as follows.

"3-
(1) This paragraph applies where -

> *(a) an individual ("the chargeable person") occupies any land ("the relevant land"), whether alone or together with other persons, and*

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(b) the disposal condition or the contribution condition is met as respects the land.

(2) The disposal condition is that -

(a) at any time after 17th March 1986 the chargeable person owned an interest -

(i) in the relevant land, or

(ii) in other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land, and

(b) the chargeable person has disposed of all, or part of, his interest in the relevant land or the other property, otherwise than by an excluded transaction.

(3) The contribution condition is that at any time after 17th March 1986 the chargeable person has directly or indirectly provided, otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of -

(a) an interest in the relevant land, or

(b) an interest in any other property the proceeds of the disposal of which were (directly or indirectly) applied by another person towards the acquisition of an interest in the relevant land.

(4) For the purposes of this paragraph a disposition which creates a new interest in land out of an existing interest in land is to be taken to be a disposal of part of the existing interest."

For simplicity this article will consider only the difficulties of interpretation in relation to the 'disposal condition'.

The problem

The difficulty in interpreting paragraph 3 is that one is obliged to consider two things at the same time

(a) Does an individual occupy land?

(b) Has that individual disposed of *all, or part of, his interest* in the *same* land?

However, the concept of the *same* land is not clear from the statute. The following example illustrates the point.

Mr Dawson's property split

Mr Dawson owns a four-storey house which has been physically divided into two maisonettes, comprising the upper and lower floors. He occupies the lower maisonette consisting of the ground and first floor. There are no separate legal interests in the land, however, and at the Land Registry, Mr Dawson's ownership of the whole house is recorded on a single title entry.

Mr Dawson wishes to make a gift of the second and third floors to his son and therefore grants a long lease of those floors in his favour. He continues to occupy just the lower maisonette by reference to his ownership of the freehold, which represents, essentially, the ground and first floors unaffected by the newly created lease.

In this example, Mr Dawson has clearly made a disposal, but will he be liable to a pre-owned assets charge? Intuitively, one would not expect a charge because Mr Dawson does not occupy the maisonette given to his son. One would hope then that although Mr Dawson continues to occupy the land and has disposed of part of it, because he does not occupy the land that has been disposed of, he should not be subject to a charge. Can the legislation be read to produce this result?

The legal interest interpretation

First, one might think that because the lease granted to the son and the encumbered freehold are two separate legal interests in land, it could simply be argued that Mr Dawson has disposed of one piece of land (the lease) and that he now occupies a different one (the freehold).

Unfortunately, this interpretation is ruled out by the specific terms of sub-paragraph 3(4) which state that "…a disposition which creates a new interest in land out of an existing interest in land is to be taken to be a disposal of part of the existing interest…". Thus, the creation of the lease out of the freehold has to be considered as a disposal of part of the freehold.

The whole house interpretation

A literal reading of paragraph 3(4) might then lead one to conclude that one has to identify all the land owned by the donor prior to the disposal i.e. here the freehold and identify whether he now occupies that land.

On this basis, Mr Dawson originally owned the freehold, he has granted a lease in relation to it and he must therefore – in accordance with paragraph 3(4) – be considered to have made a disposal of part of that freehold. As he now occupies that freehold a charge to tax would arise. This would be calculated using the formula R x DV/V. In this formula, R is the rental value of the relevant land, i.e. the unencumbered freehold. DV is the value of the interest disposed of – in other words the lease of the upper floors – and V is the value of the unencumbered freehold. Mr Dawson would therefore be taxed on a notional rent for the maisonette occupied by his son!

The purpose behind paragraph 3(4)

Applying a charge in Mr Dawson's case is contrary to the objectives of the pre-owned assets legislation, as Mr Dawson does not receive any benefit from the upper floors.

However, in many cases where the application of sub-paragraph 3(4) would produce a charge, this is clearly consistent with the general scheme of the legislation. For example, if an individual grants a lease of the whole of his house and continues in occupation, one would expect a charge.

Likewise, *Reversionary Leases* – where an occupier grants a future lease of the whole of a property to his intended beneficiaries but continues in occupation by reason of his retained freehold interest – are again a clear target of the legislation.

Is it possible then to interpret the legislation – and particularly paragraph 3(4) – in a way which still catches these cases but allows Mr Dawson to escape a charge?

I believe that this is possible but not without difficulty.

The physical land interpretation

Given the terms of paragraph 3(4), one has to accept that the creation of the lease by Mr Dawson is a disposal of part of the original freehold.

For Mr Dawson then to fall within the disposal condition he merely has also to satisfy the requirement that he '…has disposed of all, or part of, his interest in the relevant land…'.(para 3(2)(b))

'Relevant land' is defined as the land which Mr Dawson 'occupies' (para 3(1)(a)) and because we have been thinking in the context of paragraph 3(4) of the freehold in relation to the disposal, the mistake is to continue to think about that entity in relation to the occupation. If we do, we conclude that Mr Dawson occupies the freehold, which is also the land he has disposed of, and that he is therefore subject to a charge.

The way to avoid this conclusion is to treat the term 'relevant land' as being restricted to the land that Mr Dawson actually occupies *after* the disposal. One would then analyse the situation as follows.

Mr Dawson *has* created a new interest in land out of his existing interest and he must (per paragraph 3(4)) be taken to have disposed of *part* of his existing interest.

The *part* of his existing interest that he has disposed of must, however, be considered in both its *legal interest* and *physical* contexts.

The idea that the grant of a lease is a 'part disposal' is familiar to anyone used to dealing with Capital Gains Tax computations in relation to property. Had Mr Dawson granted a lease in relation his entire freehold interest, he would have made a part disposal in this context only. Here, however, he has made a part disposal in this sense *and* in the sense that the lease has been granted in relation to only *part* of the physical land – i.e. the second and third floors.

If we concentrate on the *legal interest* part disposal here it would only make sense to then consider the 'relevant land' in the same terms (and we would be back to the 'whole house' interpretation and its unfortunate consequences for Mr Dawson).

If, however, we concentrate on the *physical* part disposal and consider the 'relevant land' in that context, the 'relevant land' would be only the ground and lower floors because these are the parts that Mr Dawson occupies. When we then ask the question has Mr Dawson '…disposed of all, or part of, his interest in the relevant land…' we can answer 'no'. Mr Dawson has not disposed of part of the ground or lower floors; the part of the land he has disposed of is the second and third floors. Mr Dawson is not, on this basis, subject to a charge.

In relation to *Reversionary Lease* arrangements, the same argument could not be used where there is a part disposal in the legal interest sense only – the whole house usually (but not always) being subject to the future lease.

This 'physical land' approach therefore produces what I suspect many will regard as the most sensible result. The guidance published by the H M Revenue and Customs to date has been silent on this point, but my understanding is that they do now appear to accept this interpretation.