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The Implication of Income Tax Charge on Estate Planning

By Miss JS Byrne

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Overview

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In the Pre-Budget Report of December 2003 the Chancellor Gordon Brown announced proposals to levy an Income Tax charge from 6th April 2005 in those circumstances where the transferor of an asset retains and interest or continues to benefit from that asset. In the instance of real property, the 'benefit' envisaged is the transferor continuing to reside in the property he/she has allegedly given away.

How the Charge Applies

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The Government refer to such assets as 'pre-owned assets' and, broadly speaking, its intention is to tax the 'annual value' of such assets as a benefit-in-kind on the former owner still enjoying the use of the asset. The annual value on which the charge is based will be the open-market rental for a property or a fixed percentage of the capital value of most other assets to which the new charge applies. Any amounts which the transferor pays for the use of the asset – rent for example – will be deducted from the annual value in arriving at the taxable benefit.

The charge will also apply if a person provides the funds to purchase an asset which they go on to enjoy the benefit of after 5th April 2005.

Rationale Behind the Charge

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The charge is intended to counter many Inheritance Tax planning schemes, but unfortunately, it will also impact many innocent and unintended victims. Thankfully, the legislation has included some exceptions to the application of the charge. The charge will not apply if;

The asset was gifted before 8th March 1986

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The asset is owned by the transferor's spouse

The asset is, in fact, still caught by the 'Gifts with Reservation' rules and as such Inheritance Tax applies instead (hence, the Income Tax charge will not be levied on top).

The asset was sold at an arm's length price for cash (even if to a connected party).

The transferor of the asset had themselves inherited it and their ownership had ceased as a result of a Deed of Variation affecting that inheritance.

The transferor's continued enjoyment of the asset is merely incidental or has arisen only as a result of an unforeseen change in family circumstances.

The annual taxable benefit (after deducting any contributions by the transferor, where necessary) does not exceed £2,500.

The Inland Revenue have also confirmed that the charge will not apply in most cases where a taxpayer has funded life insurance policies held on trust. Finally, there is also an 'Opt Out' option whereby the transferor can opt not to pay the charge provided the asset is included back into their estate and therefore consequently being subject to Inheritance Tax.

The Implications of the Charge

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Most of the Inheritance Tax Planning techniques usually involve a widow or widower having continued enjoyment of their former spouse's share of the property and thus it would appear on first inspection that in the majority of cases the charge would not apply as the transferor themselves would not be around to continue to enjoy or benefit from the property.

However, a problem seems to arise where a couple own their property as joint tenants prior to commencing their tax planning strategy and subsequently changing their ownership title to tenants in common. Where the widow or widower formerly owned the property as joint tenants they had a share in ownership of the whole property. This means that the new Income Tax charge could conceivably apply to their continued occupation of the property after their spouse's death.

A possible consequence of this for the future might mean that instead of acquiring property as joint tenants which has been the general rule, the wise policy would be to own the property as tenants in common instead. But how many people are aware of this distinction? Will legal advisors be prepared to explain the tax implications of acquiring property with the different legal titles?

Conclusion

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How far will the new charge impact on current Inheritance Tax Planning schemes? As yet, it is too

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soon to tell, as the rules have not been fully fleshed out and as yet, it is too soon to say with any certainty what will happen and which schemes will be affected.

But it seem fair to argue that the current Labour Government is doing its utmost to tax its citizens at every possible turn. Inheritance Tax avoidance schemes – indeed any tax avoidance scheme –are not unlawful. Planning for the future does not mean that people are engaging in tax evasion – which IS unlawful. But the policies being employed leave an uncomfortable impression of an angry parent chastising their child simply for being astute and planning for the future!

Needless to say, the whole approach leaves a somewhat bitter taste in one's mouth.

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More Information About Taxes

By J Shipper

The first attempt to impose an income tax on America occurred during the War of 1812. After more than two years of war, the federal government owed an unbelievable \$100 million of debt. To pay for this, the government doubled the rates of its major source of revenue, customs duties on imports, which obstructed trade and ended up yielding less revenue than the previous lower rates.

And to think that the Revolution was started because of Tea Taxes in Boston?

Excise taxes were imposed on goods and commodities, and housing, slaves and land were taxed during the war. After the war ended in 1816, these taxes were repealed and instead high customs duties were passed to retire the accumulated war debt.

What is Taxable Income?

The amount of income used to arrive at your income tax. Taxable income is your gross income minus all your adjustments, deductions, and exemptions.

Some specific taxes:

Estate Taxes:

One of the oldest and most common forms of taxation is the taxation of property held by an individual at the time of death.

The US still has Estate Taxes, although there are proposals to do away with them.

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Such a tax can take the form, among others, of estate tax (a tax levied on the estate before any transfers). An estate tax is a charge upon the deceased's entire estate, regardless of how it is disbursed. An alternative form of death tax is an inheritance tax (a tax levied on beneficiaries receiving property from the estate). Taxes imposed upon death provide incentive to transfer assets before death.

Canada no longer has Estate Taxes.

Most European countries have Estate Taxes, one prime example is Great Britain which has such high Estate Taxes that it has just about ruined the financial well-being of most of Britain's Nobility which has been forced to sell vast Real Estate holdings over time.

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Capital Gains Taxes

Capital Gains are the increases in value of anything (including investments or real estate) that makes it worth more than the purchase price. The gain may not be realized or taxed until the asset is sold.

Capital gains are normally taxed at a lower rate than regular income to promote business or entrepreneurship during good and bad economic times.

J Shipper is interested in Tax Attorneys.



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