IHT & THE FAMILY HOME

It is not unusual for the family home to be the biggest asset within an estate. The following notes are designed to explain some of the options available to reduce the tax burden on your property. We are not estate planning experts so these notes should be seen as a catalyst for you to get expert advice from a tax barrister or specialist lawyer.

We should also point out that in recent years the government has been, to say the least, quixotic with regard to its tax legislation! You may well plan the passing on of your property exceptionally well now to discover in a year's time that it all has to be unravelled.

SECTION **PAGE**

1. HOW DO YOU OWN YOUR PROPERTY?

The first issue to deal with when considering tax planning and your property is how you own the dwelling. Nearly every couple will purchase a property as "joint tenants". This means that both husband and wife own the entire property equally so if either dies the property is automatically inherited by the survivor and does not go through the will or probate.

Unfortunately, this is not very helpful if you want to gift part of the property away to beneficiaries to mitigate tax or protect assets from the local authority. To do this you have to own the property as "tenants in common". This means that you each own a percentage of the home (it does not have to be a 50/50 split).

This rule also applies to all other assets and investments. If you want to use the investment in your tax planning you must separate out the ownership and not own it jointly. To change the ownership requires a simple Deed of Declaration which can be easily drawn up by any lawyer.

2. FOREIGN PROPERTIES

It is also important to realise that if you hold property abroad the rules in the country where the property is situated may be completely different to those in the UK. If you have a Spanish, French or Bermuda property use a local expert to write you a local will in the country in question, as well as handling your UK position via a suitable UK professional.

3. NEW EUROPEAN RULES

An EU law was introduced in August 2015 in an effort to deal with cross border differences with regard to inheritance.

Most EU countries have adopted the new law with the noticeable exception of the UK. ***However,*** just because the UK are not in the new regime does not mean that you cannot use the change in law to your advantage. Most clients with property in Europe have them in France or Spain, both of which are signed up to the new rules.

If you are UK domiciled, UK law states that the whole of your estate in the UK will be distributed in accordance with your UK will. UK inheritance tax will be assessed against the value of all your worldwide estate. Death duties taken in other countries will normally be offset against any inheritance tax payable.

Under the new EU law, the law of only one country can apply to the succession of your estate throughout the EU. The definition of which country that will be is:

(i) The country in which you are resident when you die ***UNLESS***
(ii) You are more closely connected with another country ***and***
(iii) You elect for the law of your national country to apply.

So the simple expedient of stating in your UK will that you wish UK law to apply to your worldwide assets should ensure that your property in Europe can be directed in accordance with your wishes. Something along the lines of:

Being a national of the United Kingdom connected most closely with the English system of law, I elect, pursuant to art.22 of Regulation (EU) No 650/2012, that my entire succession shall be governed by the law of England.

A “belt and braces” may still include a local will in the country where your property is which deals with administration (and perhaps re-iterates the above declaration), but that is something to discuss with your legal advisers.

This new law makes the whole process of owning property in Europe a great deal less fraught. See your legal advisers as soon as possible to make sure your affairs are managed to your best advantage.

4. THE NEW RESIDENTIAL NIL RATE BAND (RNRB)

Before you consider denuding yourself of your property remember the new RNRB will provide up to £175,000 per person additional allowance on death. The new legislation is a “pigs ear” in terms of drafting so please see our separate notes and consult your legal professional before taking any action.

5. LIFETIME PLANNING

The following are some of the current range of options available to move your property out of your estate:

5.1 The Rent Strategy (Entire Property)

If you gift your property to your children and pay a commercial rent then you avoid the gift with reservation (GWR) rules so, after say 7 years, you have got the property outside your estate and you are making very substantial payments to your children which in themselves is also dropping the estate value. However, your children are likely to be stuck with a capital gains tax (CGT) tax liability when you die because you will lose your principle private residence relief (PPRR) exemption. It must also be said that few can afford the commercial level of rent required.

Perhaps it is easiest to illustrate this by example:

	Property inflation is:	2.50%
	Children's rate of tax is:	40.00%
Date	**Action**	**Amount**
01/06/2015	Mr & Mrs Brown gift their property worth	£1,000,000
	Rent is paid at say a 6% yield basis	£60,000
01/06/2018	Rent review so rent increases to:	£64,613
01/06/2021	Rent review so rent increases to:	£69,582
01/06/2024	Rent review so rent increases to:	£74,932
01/06/2025	Mr & Mrs Brown die	
	Rent paid by Mr & Mrs B =	£657,517
	Value of gift kept outside of estate	£1,280,085
	Total outside estate	£1,937,601
	So IHT saved at 40%	£775,041
	CGT paid by children	£50,415
	Income tax paid by children	£263,007
	Total tax paid by children	£313,422
	So tax saved is:	£461,619

So, in this example, Mr & Mrs Brown decide to gift the whole property to their children. With a property worth this size it would probably make sense to gift it in a trust in order to protect the property from divorcing spouses, bankruptcy and other alternatives etc. As can be seen, however, the rent is very substantial and as it has to be a commercial value it must be seen to be regularly reviewed. The average person on a pension is going to really struggle to find a commercial rent at the sort of levels indicated.

We have allowed for £50,000 CGT by the children. Depending on the trust you may keep main residence relief which would mean that this charge is not payable. Not only is the estate reduced very substantially indeed, but there are no problems about “gifts out of income” legislation because the rent is a commercial transaction even though it achieves the same end result.

If the trust is a discretionary one and the value is above the nil rate band then periodic IHT charges will be due above the lifetime allowance allocated to the trust.

5.2 The Rent Strategy (Using The Nil Rate Band (NRB))

As previously mentioned the biggest problem with the rent strategy is the amount of rent involved. With the introduction of the transferable nil rate band advice is to gift the family home in chunks equal to the then nil rate band and, of course, subject to your ability to pay the rent demanded.

Let us assume in this example that Mr & Mrs Brown can afford to pay the commercial rent on a gift equal to twice their lifetime allowances (assuming no gifts in the last 7 years):

Date	Action	Amount
01/06/2015	Mr & Mrs Brown gift a share of their property	£650,000
	Rent is paid at say a 6% yield basis	£39,000
01/06/2018	Rent review so rent increases to:	£41,999
01/06/2021	Rent review so rent increases to:	£45,228
01/06/2024	Rent review so rent increases to:	£48,706
01/06/2025	Mr & Mrs Brown die	
	Rent paid by Mr & Mrs B =	£427,386
	Value of gift kept outside of estate	£832,055
	Total outside estate	£1,259,441
	So IHT saved at 40%	£503,776
	CGT paid by children @ 28%	£50,975
	Income tax paid by children @ 45%	£192,324
	Total tax paid by children	£243,299
	So tax saved is:	**£260,477**

Assuming both are still in good health it would be possible in June 2022 for the Browns to gift a further £650,000 (or whatever the NRB is going to be in 2022) because their first potentially exempt transfer (PET) of £650,000 will have fallen out of account.

Post October 2014 if the gift has been made into a discretionary trust then the periodic charges are likely to be 6% every 10 years (or proportionately 6% on transfers out of the trust) less any NRB allocated to the trust.

In 2022 Mr & Mrs Brown will be 7 years older and may feel they can afford to reduce their assets by paying higher rental payments.

By using this gradual approach if Mr & Mrs Brown have a long life there is no reason why they should pay any IHT on their property at all. Furthermore, they are going to give very substantial gifts to their children via rent albeit that that rent will be subject to up to 45% tax. If a discretionary trust is established, however, and the rent is paid out to grandchildren and to lower/non taxpayers then most of the 45% may well be recoverable in the hands of the beneficiaries.

Whilst this route is very effective, the professional fees are expensive! You need a good lawyer to establish the scheme in the first place and, of course, you need triennial rental reviews so you need to employ independent surveyors to value the property etc, and then you need to pay the periodic charges when money flows out of the trust and / or every 10 years. This will require professional help for all but the most confident.

5.3 Co-ownership

With the cost of nursing home care it is expected to become increasingly common for children to live with their aged parents in order to care for them. In these circumstances there is nothing to stop the parent gifting a share of their property to their children who are live-in carers (or just living with them). No GWR will be assumed as long as the children live in the property and the gift is exempt from the pre-owned asset tax (POAT) rules for the same reason.

5.4 Home Reversion Schemes

Home reversions have just about died out now that home income plans (roll up mortgages) are prevalent. We have in the past arranged for children to purchase the property on commercial terms. In its simplest form the home reversion works as follows:

An institution purchases the home for a discount. They will provide a lump sum and/or regular income in exchange for buying the property at a discount and benefiting from its future growth until the occupants die.

The sellers have absolute right to tenure to the property for the remainder of their life and in certain schemes they also have the ability to trade down if required. Payment can be in terms of a regular income and/or lump sum, however, in the example below I have chosen a lump sum as the simplest option:

Date	Action	Amount
	Mr & Mrs Brown's property is worth:	£1,000,000
01/06/2015	The children/trust buys the Browns property for	£500,000
	Brown's now have additional capital of:	£500,000
01/06/2025	Mr & Mrs Brown die	
	Gifts during last 10 years say	£500,000
	Value of property outside the estate	£1,280,085
	Total outside estate	£1,780,085
	So IHT saved at 40%	£712,034
	CGT paid by children @ 28%	£78,424
	Income tax paid by children	0
	Total tax paid by children	£78,424
	So tax saved is:	£633,610
	If the purchase cost had been invested at 4% net pa it would be worth:	£740,122
	so net benefit becomes:	£393,488

So Mr & Mrs Brown have a property worth £1 million and, because of their age, the discounted capital sum the children pay them is £500,000. With this additional sum, as part of their overall assets, the Browns are able to increase their gifts out of income for IHT purchases or even gift a lump sum to another dependant (this cannot benefit the purchaser).

Again, using similar assumptions to that which I have used above you will see that by the time they die in 2025 the property outside their estate is £1,780,000 so the overall IHT saved is about £633,000, albeit that the children have lost the growth on their funds elsewhere. Please note we haven't allowed for costs or SDLT so you could probably deduct another £100,000 from the proceeds.

Of course, the big difficulty of this route is that the children have to find £500,000! On the other hand, this of course has an immediate IHT saving. It would, therefore, be worth trying perhaps to achieve a very rapid IHT saving rather than some of the more traditional schemes which entail a very long lead time to substantial savings.

The extent of discount which you get for a home reversion depends upon your age. We would also recommend that clients wishing to undertake DIY home reversions ensure they have a statement from their doctor indicating their overall state of health to avoid any attack from the Revenue. Whilst a commercial home reversion does not have to take into account health, we can see a challenge from HMRC in similar terms to the challenge they could conceivably make on a pension contribution for an individual who is in severe ill health.

5.5 Carving Out A Lease

Not that dissimilar to a home reversion plan, Mr Brown creates a lease on his property which enables him to live there for 20 years tax free. He then sells the freehold at a significant discount to his son. The end result is similar to the home reversion.

5.6 Roll Up (Or Interest Only) Mortgage And Gift

The Home Income plan, equity release or roll up mortgage is now becoming very popular. Cash released can be used to make gifts to your children. The whole process is done on commercial terms and what you wish to do with your mortgage lump sum is entirely up to you (watch deprivation of assets for nursing home care).

5.7 Downsize

As we get older the hassle of maintaining larger properties can be a real burden. The simple expedient of selling and buying a smaller property will both save on maintenance costs and will release cash to make potentially exempt transfers (PETs) and hence reduce the estate for IHT purposes. Remember, however, your property wants to be worth at least £350,000 if you want to benefit from the RNRB.

5.8 Sell Up And Gift

Mr & Mrs Brown sell up and go off on a grand adventure. From the sale proceeds they make a substantial gift to their son. Son decides to use the cash to build a big granny annex into which Mr & Mrs Brown decide to live when they return home.

This is not a reservation of benefit as the gift was not used to buy the property.

5.9 Holiday Home

Why not plan early for your retirement holiday home? If you make a gift of cash to your children and they use this to buy a holiday home in a suitable venue, then as long as you do not use the holiday home (or if you do you pay a commercial rent) after the gift has been made the gifts remains outside your estate.

5.10 Rented Property

Mr & Mrs Brown own a property worth £200,000. They decide to give their daughter 90% of the property retaining 5% each. However, part of the gift is an agreement that Mr & Mrs Brown can keep all the rent.

This is a PET for IHT purposes as Mr & Mrs Brown do not live in the property.

There is a trust version of this route which is slightly more secure (with regards to the income).

There will also be CGT on the value when the gift is made.

6. TAX PLANNING WHEN YOU DIE

6.1 Using Your Property For Part Of Your Nil Rate Band Trust

This now only applies in the circumstances where someone required a Nil Rate Band Trust (NRBT) on first death and has not got ready funds and their share of the property can form part of the NRBT. To achieve this, the property has to be owned as "tenants in common" which is a legal state where you own your share of the property completely separately (as opposed to the normal joint tenancy whereby you both own all the property together).

A further version of this is to create a NRB trust and then use, say, £25,000 to keep a small share of the property in the trust and then pass the remaining cash in the trust to the surviving spouse (thus preserving almost 200% of the NRB).

The fact that the trust owns a small % of the property means that the value on second death is reduced, typically by 10% to 15% for IHT death benefit on second death (see 4.3 below).

Please see our article “IHT and Wills” for further information.

6.2 Using An Immediate Post Death Interest Trust (IPDI) Instead

In the simple case of a married couple (or couple in a civil partnership) where the ultimate beneficiaries are not going to be in dispute (ie, the children of the marriage) then changing the wills from an NRBDT to an IPDI would mean that on the second death:

- the property would have grown free from CGT, and
- the NRB would have increased by inflation.

Any other assets of the estate could be put into a discretionary trust (or gifted) under a PET by the surviving spouse and in this way further IHT savings could be made once the surviving spouse has lived a further 7 years.

There are still valid arguments to use the NRBDT approach. For instance, if assets are in an NRBDT they are not available to the surviving spouse so cannot be means tested if the surviving spouse goes into a care home. If it is a second marriage then using a NRBDT may be a safer option to protect children of one spouse over another.

6.3 The Rent Strategy

The rent strategy is basically the same as outlined in 3.2 above. Mr Brown dies and leaves his estate in an IIP (or IPDI) to Mrs Brown. Mrs Brown gifts £300,000 of the property to the children and then pays rent. Assuming Mrs Brown lives only 7 years, not only have we used Mr Brown’s full NRB revalued with inflation between the time of his death and the time of Mrs Brown’s death, but also you are making use of the NRB on one or more occasion. Of course, the problem with this route remains the issue of remarriage etc, but as the IPDI has the children of the first marriage as its ultimate beneficiaries this will at least provide some safeguards.

When thinking about this strategy we have used the following assumptions:

Property inflation is:	2.50%
Property on first death is worth	£1,000,000
Rental yield is	6.00%
IHT joint property discount is	15.00%

The only assumption that really needs explanation is the joint property discount. It is accepted by HMRC that when you own half of a property its worth is not 50% of the true value due to the right of tenure of the other spouse. The 15% discount we gather is typically achieved in discussions with HMRC.

Date	Action	Amount
01/06/2015	Mr Brown dies and passes his share of the house to an IIP for Mrs Brown	£500,000
01/07/2015	Mrs Brown gifts to children	£325,000
01/07/2015	Rent is paid at say a 6% yield basis	£19,500
01/07/2018	Rent review so rent increases to:	£20,999
01/07/2021	Rent review so rent increases to:	£22,614
01/07/2024	Rent review so rent increases to:	£24,353
01/07/2025	Mrs Brown dies	
	Rent paid by Mrs Brown is:	£213,693
	Value of gift kept outside of estate	£416,027
	Joint spouse discount	£75,000
	Total outside estate	£704,720
	So IHT saved at 40%	£281,888
	CGT paid by children @ 28%	£25,488
	Income tax paid by children @ 45%	£96,162
	Total tax paid by children	£121,650
	So tax saved is:	£160,239
	Plus 200% of NRB still available for other assets	

Please note - Post October 2014 there may be periodic IHT charges of up to 6% to be paid every 10 years or when the property is removed from the trust.

6.4 Post Death Planning

Some would say surprisingly there has been no attempt to change the provisions which enable the variation of a will by the wills' trustees within 2 years of the date of the death of the testator. This in effect means that if you discover the will has created a position you are not happy with you can simply rewrite it to best effect! Potential use of this variation/disclaimer can be to resolve ambiguities within a will, to achieve fairness due to changes subsequent to the will being made, and obviously to save a bit of tax. This is a hugely important tax planning vehicle which we expect to in some way be curtailed in the near or distant future.

7. SECOND HOMES

To some extent you can apply all of the main residence solutions to second homes and rented accommodation as well. The problem with second homes is trying to create structures which will reduce both CGT and IHT. The recent increase to SDLT has also made second homes less attractive in pure tax planning terms.

The following are some general ideas although the "devil is in the detail" so expert advice is always required.

Some of the following ideas are now a few years old and may have been superseded.

7.1 Family Debt Arrangement

This works as well for almost any investment. Let us say you have a property worth £1 million with £500,000 of gains. First, create tenants in common then transfer the ownership of the property to, say, the husband. The husband then sells the property to his wife (no CGT to pay) and wife pays with an IOU (she will have to pay SDLT on the equivalent which on a £1 million will be around £50,000).

Having got the IOU the husband gifts the IOU to the children. Hopefully, husband lives 7 years so the IOU falls outside of the estate. He has not had any benefit from the gift so it is not a GWR and because he sold it commercially to his wife it is not POAT.

7.2 Gift To Discretionary Trust With Holdover Of CGT

Again, following the above example let us assume that if the property is owned by the husband he gifts half of it to his wife. Both spouses then gift the property into a discretionary trust (using both their nil rate bands).

- The gift is a chargeable transfer, however, as it is within their NRB no IHT to pay.

- No CGT to pay as can hold over the gain into a discretionary trust.

Now the property is in the trust then as long as no benefit is derived by the settlors within 7 years the property will be outside the estate. There will however be 28% CGT to pay when the property is finally sold and periodic IHT of up to 6% of the property value plus up to 45% tax on any rental yield generated.

7.3 University Funding

We have in the past bought properties for adults, children/grandchildren who are going through university. We would usually use a trust which will ensure that any gains in the property fall under the PPRR rules for the child, and further that any income generated from subletting the property also falls into the child's taxation. The trust would, however, prevent the property being charged by A N Other or claimed by third parties for outstanding bar bills, maintenance of children etc etc! As ever the trust needs to be carefully worded to avoid pitfalls.

8. OTHER IHT NOTES

We have a number of other notes relating to IHT issues. These can be found on our website library.

Please note that whilst every effort is made to ensure that the information contained within this explanation is correct, these notes are by necessity brief and of a generalised nature. Clients should seek specific personalised advice prior to undertaking any arrangement. These notes are named 11.2017 IHT & The Family Home and were last updated in November 2017. Whilst we have done our best to ensure facts are current to this date laws and options are changing constantly so always check before action.

E.&.O.E.