



The Family Home: Inheritance tax mitigation through lifetime giving

BRIEFING

The exemption from Capital Gains Tax (CGT) on selling one's only or main residence is well known.

Unfortunately there is no similar exemption or relief from Inheritance Tax (IHT) for the home – apart, that is, from the rather specialist subject of farmhouses which may attract agricultural property relief at up to 100%. The difficulty is that, despite the recent downturn in the housing market, the values of many homes will be well in excess of the nil-rate band.

And so, apart from the exemption for transfers between spouses or civil partners, IHT at 40% on the then market value of the house is going to mean in very many cases that the house will simply have to be sold to pay the tax. The greater the number of children and the more that parents want to split assets equally in general terms, the more likely is this to be the case. So, what's to be done?

Incidentally, while a matter for will planning rather than lifetime giving, the transferable NRB for IHT introduced for married couples and civil partners from 9 October 2007 (which allows any unused proportion of the NRB on the first death to be carried forward to the second) is going to prove useful in the context of mitigating IHT on the family home on death. The difficulty, however, is that the family home may well be worth rather more than two NRBs and of course other assets also have to be taken into account.

Anti-avoidance Legislation

The obvious thing to do might appear to be simply to give the house to one or more children (or to trustees for them, to ensure security) and carry on living in it. The difficulties are:

- The reservation of benefit (GWR) regime. This was introduced in 1986, rendering ineffective a gift of an asset which the donor continues to enjoy. If that happens, the individual is simply treated as continuing to own the asset for IHT purposes either until his death or until he ceases to benefit, triggering a gift at that point. Although there are certain de minimis rules (under which, for example, you could give your house to your daughter in which she then lives and you visit her for up to a month in the year), they are not going to help in the typical case.

Some attempts have been made over the last 20 years or so to get round these GWR provisions. HMRC got rather fed up with these and so further anti-avoidance rules were passed in 2004:

- The pre-owned assets (POA) regime. Under these rules where in particular there has been a disposal of a house (which interestingly could include some sales as well as gifts) which the donor continues to enjoy and the case is not caught by GWR, there is an



annual income tax charge based loosely on the market value of the benefit.

And as if all that were not enough;

- The 2006 IHT alignment for trusts means that a lifetime gift of an asset into almost any trust, including a non-discretionary trust, will be an immediately chargeable transfer and so will trigger IHT at 20% to the extent that the transferor's 7 year cumulative total exceeds his NRB.

Traditionally, IHT-efficient mechanisms for 'having your cake and eating it' have relied upon a gift into a non-discretionary trust to preserve the family home for the children from horrors like matrimonial breakdown or even personal insolvency.

So, what are the options?

There are one or two arrangements in the market place which might be regarded as sailing close to the wind. This briefing steers a wide course of those. However, based on specific exemptions within both the GWR and the POA regimes, there do remain four possibilities outlined below. We should emphasise that what follows is written in very general terms only. While we should be happy to discuss with any of our clients one or other of these options, we should emphasise that their implementation and indeed continued monitoring does require very careful attention.

Full Consideration Lease

Neither GWR nor POA applies where following a gift any benefit of occupation on the part of the donor is enjoyed 'for full consideration'. In broad terms this means paying the sort of price, e.g. by way of market rent, which an unconnected person would pay to occupy that property. So in its very simplest terms father and mother might give their house to their daughter and the daughter would then grant them periodic leases back.

An annual rent

The gift would be a potentially exempt transfer (PET) by each of the parents, so with no IHT implications so long as each survives for at least 7 years.

Assuming the property is their only or main residence, any gain (and do remember that a gift is a disposal just as much as a sale) should be relieved from CGT. The particular future downside for the daughter might be CGT, in that she would own a property which she hopes would appreciate in value but from which she will not get the benefit of main residence relief for her period of non-occupation – except of course to the extent that she occupies it as such after her parents' deaths. Alternatively she could retain the property until her own death, when under current legislation there is the CGT-free uplift to market value at that time.

A straight gift is exempt from Stamp Duty Land Tax (SDLT). However, bear in mind the possible trap that where the property is subject to a mortgage and the donee takes on the mortgage



that counts as consideration, specifically for SDLT purposes (and for IHT would reduce the value of the PET). To the extent that for residential property the mortgage debt exceeds £125,000 there would therefore be SDLT to pay.

That full consideration is given can be demonstrated by having independent surveyors and perhaps solicitors for the parents on the one hand and the daughter on the other, agreeing the annual rent on the basis of a lease with its particular repairing and maintenance obligations. Typically there would be provision for a 3 year renegotiation of the lease. The rent is paid, the daughter pays income tax and everyone is happy. Of course this does mean real cash being paid over by the parents and so assumes that they can afford to do so. If they have surplus capital cash they could consider a variant of the rental scheme, as follows.

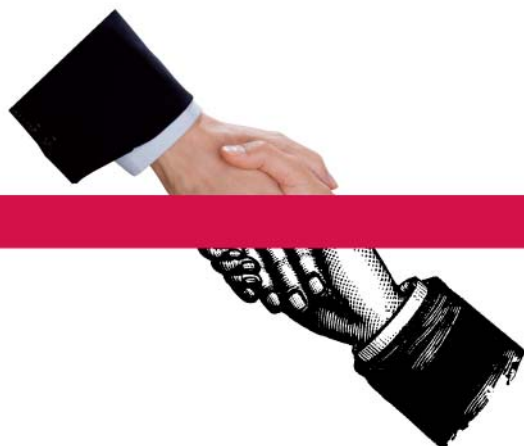
Full consideration premium

The parents would buy a lease for the rest of their lives, that is the anticipated life of the two of them and the survivor, which can be computed as a period of years on an actuarial basis. The question then becomes: what would an unconnected third party pay to occupy this house on specified terms as to maintenance and repair for that period of time? The answer is a cash sum – or perhaps an average cash sum on the basis of two or three actuarial opinions. Either the minimum or the average is paid. Being for a lease of typically less than 50 years, part of the daughter's receipt will attract income tax at 40%. However the twin advantages of this route over the simple lease are:

- The cash sum would leave the parents' estate not by way of gift but by value, so acquiring the classic IHT valuable asset which disappears on death. Accordingly, there would be no IHT implications if say a year later both parents were tragically killed in a car crash.
- Once the proper amount has been ascertained and paid as full consideration, there can be no come back by HMRC. Under the lease route it is essential that throughout the period running from the date of gift to the date of death full consideration is paid. The danger is that for say the first 10 years full consideration is paid and then for some reason during the last 6 months of the lease before death the rent falls below full market: in that case the GWR rules will claw back into the relevant donor's estate the whole of the then value of the property.

Sale for Full Consideration

Suppose that it is not so much the older but the younger generation who is the proud possessor of spare cash. In this case the parents might sell say to their daughter their property for full consideration subject only to a right to remain there for a period of years. This is the classic equity release scheme which traditionally might be done with a life assurance company. It is important incidentally that the period of remaining occupation is for a fixed term of years and not for life. Again, it is essential that the right price is shown to have been computed and paid. And perhaps the easiest way to demonstrate this would be through getting the figure and terms from an



independent commercial provider of such arrangements – even though it might seem a bit cheeky to ask them knowing that one was not going to proceed!

In this case there would be an immediate reduction in the parents' chargeable estates. Before the transaction they have a property worth say £1 million, whereas after they have in their estates say £800,000 cash plus the right to occupy the property for the next X years. But, however the transaction is documented legally, that would be a personal right only and will die with them. Obviously the cash remaining in their estates will prospectively be chargeable to the extent that it is not spent and does not form the subject of PETs to other members of the family (not the child who buys the house!) coupled with survivorship for 7 years. For CGT purposes the analysis is the same as the lease idea.

The acquiring child will have to pay SDLT at 4%, given a value of more than £500,000.

In one sense, given that one of the children does have available cash, this carries the advantage over the lease idea that the parents do have security of tenure for the fixed term of years.

Co-occupation (and Co-ownership)

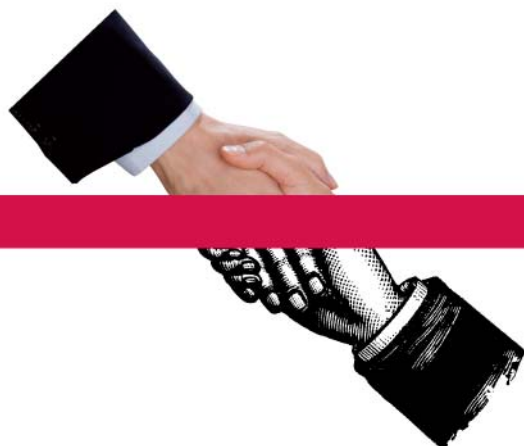
There is an interesting exemption from the GWR regime, carried over to POA in 2005/06, which applies where one or more persons (not necessarily members of the same family) own property together as 'tenants in common' in specified shares, which may be equal or may be

unequal. Under a 'tenancy in common' any joint owner can give or leave by Will his share to anyone else. (By contrast, under a joint tenancy, the share of a joint owner passes on death to the surviving joint tenant(s), equally if more than one.) There would be a gift by one or more parents of specified share(s) in the property to one or more children.

What is essential to the analysis is that each of the co-owners 'occupies' the property, though not necessarily as their only or main residence. Indeed, HMRC's current views on the meaning of occupation for POA purposes (which could not reasonably be refused in the context of GWR) state that a person occupies a property for any year when he stores his possessions there and visits the property for however short a period.

The point then about occupation is that, even though not the main residence, perhaps of any of the members of the family as this could equally well suit a holiday home, it can be shown that each of the co-owners does occupy through the year, by virtue of visiting the property and storing possessions there – and indeed also having a key.

The other principal condition for this exemption is that the donor receives no benefit 'referable to the subject-matter of the gift'. The situation should be avoided where say parents and two daughters occupy but all the living expenses are paid by the daughters. There would then be a benefit for the parents and so there would be a reservation of benefit. In terms of payment of expenses, there is incidentally no problem if the donor(s) pay(s) all the expenses, but this is likely to be undesirable.



The important point, and this does require some attention to detail, is that a careful record should be kept of all the expenses, whether relating to the property itself (eg repair bills) or relating to living expenses (eg food and drink, TV licence etc). The property-related expenses should be borne in the shares in which the property is owned, eg one quarter each, and the living expenses should be borne in the proportions actually enjoyed by each of the co-owners.

In terms of the tax implications of the gift, these would be as for the lease idea, for all of IHT, CGT and SDLT. The CGT analysis would depend on whether or not the property were indeed the only or main residence of the parents. As for IHT, given a PET, that would fall out of account once the seven year risk period had passed.

Holiday Homes

The co-ownership/co-occupation exemption works to our mind particularly well with holiday homes. Obviously the circumstances will vary from family to family. In an ideal world following a gift of up to the whole of their interest in the property, it might be shown that there was no occupation at all on the part of the donors within the meaning of the GWR and the POA regimes. However, this may be unlikely, as it would typically assume that the donors spent no more than two weeks in the year in the property without the donees, did not store their possessions there and did not have rights to be there when they were not in occupation (and so did not retain a key outside such periods, for example).

The co-occupation exemption may well suit the circumstances as the occupation by the co-owners can be successive and need not be concurrent. Here the point about sharing expenses is crucial.

If the co-occupation provisions do not apply for whatever reason and there is no reservation of benefit, POA can be avoided if the benefit does not exceed £5,000 per taxpayer per tax year, which arguably could relate only to the periods of the year for which the taxpayer was entitled to enjoy occupation.

If all of this sounds too complicated, it may be easiest for the parents simply to pay full consideration for the periods of occupation, in which case of course they could safely (in the context of IHT, at least) give away the whole of their interest in the property.

Potentially Exempt Gifts of Cash

Suppose that mother gives son £500,000, son buys a property and mother goes and lives there rent-free for periods which are not exempt under the GWR provisions. On the face of it there ought to be a GWR. However, although there are rules in the GWR regime which allow HMRC to trace property through various changes, tracing generally stops with cash unless one falls foul of the associated operations provisions. So, for example, there probably would be a GWR if mother said to son 'I'm giving you £500,000 on condition that you buy a cottage in which I'm coming to live'. But let's assume this is not the case, so it should be easy enough to avoid GWR.



POA is a bit more difficult. And here on the face of it there would be a problem apart from a specific let-out. The let-out provides that if, following a gift of cash, the donor does not occupy the property for at least seven years there will not thereafter be POA. The seven year condition might seem to be a bit restrictive, though it could perhaps apply in anticipation of certain events. For example, father knows that he is going to retire in seven years time or maybe he is working abroad and will come back to the UK after a similar period. Provided that everyone was happy that he then occupied a cottage by the sea owned by one of his children, a gift of cash now could set up the scene for the purchase by the child which they might rent meanwhile or use as a holiday home in anticipation of parent coming back to retire there.

Postscript: Capital Gains Tax and the Second Home

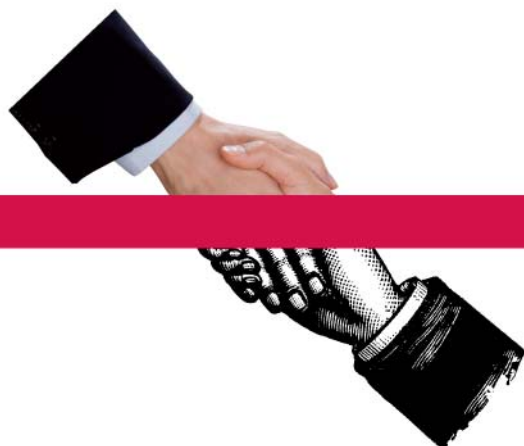
Second homes which are not covered by the main residence relief from CGT have a tendency to appreciate in value just as much as the main residence. Here there is going to be a problem with a lifetime gift – and despite the reduction in the rate of CGT from 40%, this can still lead to a sizeable tax bill. Prior to 10 December 2003 it was possible to adopt quite a neat arrangement, subject to values, involving a gift into a discretionary trust within the NRB followed by occupation of the property by one of the children as a beneficiary, with the effect that the whole of the in-built gain was effectively relieved. Since then, however, such an arrangement is not possible: while a gift into trust can defer the chargeable gain, the gain arising on coming out of

trust can no longer be protected by main residence relief. However, one stratagem does remain, involving the relief for 'furnished holiday accommodation' (FHA).

Furnished holiday accommodation

The property must satisfy certain conditions, for example the property is available for letting by the public for at least 140 days in the tax year, it is actually occupied as FHA for at least 70 days and for a period comprising at least seven months it is not normally in the same occupation for a continuous period exceeding 31 days. Property which is FHA is treated as a business asset for both income tax and CGT purposes. And so in particular for CGT it will attract the hold-over relief under which CGT can be deferred on a gift of the business asset until sale of the asset by the donee.

Let's suppose that the husband owns the second home in a holiday area. He gives it to his wife on a no gain no loss basis. She then lets it as FHA over a period of say 12 months (which, incidentally, does not preclude occasional use by the family). So throughout her period of ownership it becomes a business asset. She then gives the property to a child who occupies it as his only or main residence and on sale complete CGT relief will apply. The IHT and SDLT analysis will be as above. CGT exemption will apply so long as throughout the child's period of ownership (or all but the last 36 months) he has occupied the property as his only or main residence. Again, this like the IHT arrangements suggested above must be constructed and monitored carefully. But it does



offer the prospect of CGT-free gains – within the law.

We should be happy to discuss any of these arrangements with our clients on request. You should always bear in mind that tax saving is not the only object in the world: it is never worth sacrificing security of tenure or family harmony for the sake of IHT efficiency.

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