

Inheritance tax planning and the family home

An overview and options for lifetime planning

Introduction

Leading tax and legal experts agree that a family home should only form part of an inheritance tax planning exercise as a last resort. Wherever possible, it is usually preferable to look towards other asset classes when considering planning of this nature.

However, property values have risen considerably over the past 20 years and this means that more and more people are likely to be subject to inheritance tax (IHT) due to the value of their property. Accordingly, where the family home represents the main asset of the estate, it cannot be easily ignored where inheritance tax mitigation is a priority.

Unfortunately, tax planning opportunities involving the family home are limited, with legislation, case law and HM Revenue & Customs (HMRC) practice restricting the effectiveness of IHT schemes involving property.

Other major considerations include:

- safeguarding the future residential, as well as financial, security of the homeowner(s);
- catering for future changes in circumstances, for example entering a nursing home or wanting to move house; and
- the interaction of other taxes like capital gains tax (CGT), stamp duty land tax and the pre-owned assets tax.

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Nevertheless, there are still opportunities for utilising the family home in IHT planning. This series of factsheets looks at the most commonly encountered arrangements and their advantages and possible disadvantages. This factsheet primarily considers lifetime planning opportunities whilst the second looks at planning using wills.

These factsheets assume that the homeowner(s) is/are UK domiciled and that the family home is situated in the UK.

Friends Life cannot give specific advice on the suitability of any such scheme. Individuals should seek professional legal advice before taking any action in respect of their home.

Co-ownership of property

There are two ways of holding property jointly – as joint tenants or as tenants in common.

Joint tenants

The owners own the whole of the property together and each is deemed to have an equal share.

On first death, the deceased's interest passes automatically to the survivor and cannot be bequeathed under the deceased's will. For IHT purposes, there will be a transfer of value of half the value of the property although if the couple are married or in a civil partnership, this transfer will be exempt.

A joint tenancy can be severed during the owners' lifetime to create a tenancy in common. Subject to the agreement of relevant beneficiaries, a joint tenancy can also be severed retrospectively to make use of the nil-rate band on first death.

Tenants in common

The owners each hold a distinct share of the property, which can be unequal - for example to reflect each owner's contribution to the purchase price.

Each tenant's share is a separate item of property and can be disposed of during the owner's lifetime or under the terms of their will. For this reason, tenancy in common is the most suitable way for co-owners to hold property from an IHT planning perspective.

In the absence of a will, the deceased's interest in the property will be dealt with under the laws of intestacy. This can produce an undesirable result especially where couples are not married or civil partners.

When a co-owner dies, the IHT value of the deceased's share in the property will be discounted by around 10-15% to reflect the restricted demand for the part shares in property

Lifetime planning options

The main taxation obstacles to effective lifetime IHT planning are the gift with reservation (GWR) and the pre-owned assets tax (POAT) provisions. These rules severely restrict the scope for planning of this nature, however, there are some options available that are considered later in this factsheet.

Gifts with reservation (GWR)

A GWR is, in essence, a gift from which the donor can still continue to receive some benefit. If a gift is a GWR, the value of the gifted assets is, in effect, brought back into the donor's estate immediately before death. This negates the IHT benefit of making the gift.

Therefore, on death, an individual who had transferred legal ownership of their home to another individual or trustees but still lived there would not benefit from a reduction in their estate for IHT purposes.

GWR exemptions and lifetime planning

There are certain statutory exemptions from the GWR provisions. Some lifetime IHT planning arrangements make use of these exemptions, however, their application is fairly limited.

Gifting property and paying market rent

The market rent or 'full consideration' exemption applies where an individual makes an outright gift of the home but continues to live there, paying the donee the full market rent.

Main advantages

- avoids GWR provisions.
- gift is regarded as a potentially exempt transfer (PET) if to one or more individuals absolutely.
- payments of rent may be a useful, IHT effective, method of passing funds to the next generation. (in addition to amounts that may be also given using the annual allowance or normal expenditure out of income exemption)
- the property value would be disregarded in any assessment, of the donor, for support with care fees (unless it could be proven that a significant reason for making the gift was to avoid its inclusion in such an assessment).

Possible disadvantages

- full commercial rent must be paid to the donee.
- rent is funded out of after-tax income.
- rent is taxable in the hands of the donee.
- the donor's tenancy must include rent reviews.
- if the gift was not to an individual or to certain special forms of settlement, then it would be a chargeable transfer and immediately chargeable to IHT.
- the donor would have to survive seven years for a PET to fall outside of the estate.
- the donor's security of tenure is under risk, for example, the donee could be declared bankrupt, divorced, die prematurely or wish to sell the property.
- the donee will not be eligible for CGT principal private residence relief, for the period of the donor's residence, on eventual disposal of the property.
- unlikely to be popular with clients who may be unwilling to pay rent to live in what they consider to be 'their' home.
- the home would be lost as a future source for a lifetime equity release.

Gift of share of property with co-owners sharing residence

In the co-ownership exemption, a share in the home is gifted absolutely and the donor and donee live in it together as their main residence with each also contributing proportionately to the running costs.

Main advantages

- avoids GWR provisions.
- gifted share is regarded as a PET.
- CGT principal private residence relief applies.

Possible disadvantages

- concerns for security of tenure.
- donee must be willing to live in the property as their main residence. If they move out, GWR provisions will apply unless the donor pays a commercial rent for the use of the donee's share of the property.
- donee must meet their share of the running costs from their own resources.
- the donor would have to survive seven years for the PET to fall outside of their estate.

Pre-owned assets tax

The pre-owned assets tax (POAT) charge was introduced, with effect from 6 April 2005, in an attempt to counter contentious IHT planning arrangements – many of which involved the family home.

POAT will apply to persons who continue to derive a benefit (other than for full consideration) from an asset that they formerly owned, or provided the funds to purchase.

Individuals caught by the POAT rules face an increased income tax liability unless they elect to have the value of the relevant property back in their estate for IHT purposes, unravel the arrangement or pay a fair market rent for use of the property.

POAT exclusions

There are certain exclusions from the POAT provisions, including genuine arm's length sales and where an asset still counts as part of the donor's estate under GWR.

A disposal of a part share of a property at arm's length is also an excluded transaction. This covers genuine equity release arrangements with arm's length providers.

One exclusion from POAT that does offer some very limited scope for planning concerns cash gifts. If there is a gap of at least seven years between the gift and the donor first occupying a property bought with that cash (or its proceeds) then the donor's occupation would not trigger a POAT charge.

Other lifetime planning possibilities

There are a few remaining practical lifetime planning opportunities that are not caught by either the GWR or POAT rules.

Unlocking capital by moving home

This may be popular with many older people who wish to downsize to a smaller, more manageable, and less expensive residence. As a result, surplus cash proceeds could be used for IHT mitigation purposes (for example, as PETs).

Main advantages

- efficient and effective way of achieving IHT benefits.
- cash released is tax-free.
- IHT planning is not reliant on 'borrowed money' as in the case of equity release schemes.
- CGT principal private residence relief applies.

Possible disadvantages

- the homeowners must be amenable to selling the family home.
- legal and other moving costs.
- stamp duty land tax may apply.

Remortgaging / equity release

Homeowners who have built-up a significant level of equity in their family homes have the opportunity to release some of the capital for IHT planning purposes.

Main advantages

- cash released is tax-free.
- security of tenure can be guaranteed with most arrangements.
- funds could be gifted or invested in assets that do not attract IHT such as unlisted trading companies.
- mortgage debt will reduce value of estate for IHT purposes.

Possible disadvantages

- mortgage repayment costs (unless an equity release scheme where interest rolls up).
- may affect eligibility for state benefits.
- risk of 'negative equity' situation.
- client remains responsible for maintaining property
- may restrict future options such as downsizing and funding long-term care.

Home reversion and investment bond combinations

This type of arrangement is a relatively new concept. It involves the sale of the property to an insurer in exchange for a rent-free lifetime lease and a cash lump sum. The lump sum can then be used to purchase an investment bond linked to a fund that comprises all of the properties the insurer has purchased to date. The bond is normally gifted to the client's heirs.

The bond provides a death benefit initially in the region of 90-95% of the property value. This may rise or fall with the value of the property fund. On death, the family are offered the opportunity to buy back the property at the open market value.

Main advantages

- security of tenure.
- if the bond is gifted to an individual or individuals absolutely and the donor survives 7 years, then the proceeds will be free from IHT.
- even if death occurs within 7 years of gifting the bond, the donor's IHT liability will be significantly reduced. This is because the bond has a considerable life assurance element and the death benefit of the bond is, therefore, higher than the bond premium (i.e. the value of the gift). Therefore, the amount chargeable to IHT would be less than that removed from the estate.
- family able to repurchase home on death, if desired, although there is no certainty that the bond proceeds will be sufficient to cover the purchase costs.
- sale of property (and purchase of lease) at commercial rates should avoid POAT and GWR provisions.

Possible disadvantages

- high cost – initial charge in region of 6.5% of property value.
- high minimum value for property to be eligible.
- untested – HMRC's attitude to such schemes is unknown.
- client remains responsible for maintaining and insuring property.
- client is no longer the homeowner, therefore, will not financially benefit from:
 - any subsequent improvements, which would have to be sanctioned by the scheme provider, they make to the property
 - although the scheme allows the client to move, at their own expense, any further cash realised by downsizing will go into the fund
 - any increase in value in their property (if it exceeds the other properties in the fund)

- gains made on the bond will be subject to income tax at some point, whereas, if the property had been retained, increases in value would be exempt from CGT under the principal private residence relief.

Conclusion

There are significant barriers to using the family home in a lifetime IHT mitigation exercise. Foremost amongst these are the GWR and POAT provisions – taxation legislation designed to thwart “have your cake and eat it” planning.

It should be noted that there are other matters, besides tax considerations, that need to be taken into account when contemplating use of the family home in this manner. Local authority support for residential and nursing home care fees may be compromised where a claimant has gifted away their family home, under the “deliberate deprivation” rules. Other potential issues include the legal costs of having documents drafted, moving costs, and an undermining of the homeowner's security of tenure.

Important information

This factsheet is based upon our understanding of current tax and other legislation at the release date and may be subject to change in the future. Whilst every care has been taken to ensure the accuracy of this information, Friends Life can accept no responsibility for any actions taken as a result of this release.

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