

Tax Planning Via the Family Home

Take a typical example, Arthur and his wife Angela. Their circumstances are summarised in the box. They have a heavy IHT liability when they both die (or at least, their children do); what can they do?

<p>Arthur and Angela are just retired and have been married for longer than they care to admit. They have three adult children whom they trust implicitly. Two of their children have given them grandchildren. Arthur and Angela have failed to build up adequate pension funds, and rely on the income from their investments, which are low yield equities; they own assets split between them as follows:</p>			
	Arthur	Angela	Joint names
Their home (they live alone)			£2,000,000
Investments	£500,000	£350,000	
Cash	50,000	100,000	
<p>If their wills leave their estates to each other, then on the second death IHT will be payable on a combined estate of £3,000,000. After the Nil Rate Band of £300,000 (2007/08), the rest is taxable at 40%; IHT of £1,080,000. Even if they use Nil Rate Band Discretionary Will Trusts, the tax will still be £960,000.</p> <p>If they give away some of their securities, they will lose the income from them and pay Capital Gains Tax (CGT) on the notional gain arising from the gift, both of which are unacceptable financial burdens.</p> <p>So they think maybe they should do some tax planning involving the family home instead.</p>			

The various options for tax planning with the family home are described below, the first not really being an option at all and others being very costly in tax terms, only suitable for people in limited specialised situations.

What is a Gift with a Reservation of Benefit (GROB)?

You should only make gifts if you feel totally comfortable with the knowledge that once given, any such asset can no longer be used for your benefit. If you continue to benefit from the assets gifted then the gift will be ineffective for inheritance tax purposes and the value of that gift will be included in your estate.

What is the Pre-Owned Assets Tax (POAT)?

POAT is an income tax charge on the benefit obtained from the continued use of assets by a former owner. Tax planners over the years had developed various approaches to avoiding the reservation of benefit rules. By introducing the POAT in 2004, the Revenue were able to tax transactions involving land, chattels and settled intangible property which were gifts but were not caught in the IHT net (because they were designed to circumvent a GROB). The POAT regime has closed up a number of previous loop holes.

When considering tax planning with the family home it is important that the POAT charge is kept in mind. Depending on the asset involved it may involve complex issues, and the calculation of the POAT charge is not easy.

What is the CGT exemption for a house?

On the disposal by gift or sale of an individual's main or only residence, any gain arising is exempt from CGT. A husband and wife living together have only one principal private residence exemption. Where a taxpayer owns more than one residence, he can elect for one to be treated as his main residence.

What is the CGT uplift on death?

Death provides an automatic CGT free revaluation of assets. The value of each asset as at the deceased's date of death becomes the acquisition cost for the asset in relation to subsequent disposals of it by beneficiaries, personal representatives and trustees. The consequence of this is that in-built gains accruing during the lifetime of the deceased are not charged to CGT. This point needs careful consideration as part of general estate planning. The disposal of an asset during an individual's life could result in an immediate liability to CGT if the gain exceeds the annual exemption available or if there are no reliefs available.

Option 1 – Gift house to children/adult grandchildren, and stay in residence**Proposal**

Transfer the ownership of the house to the three children equally, whilst Arthur and Angela continue to live there by consent. None of the children move in.

Good Results

None, except that at least there is no POAT.

Bad Results

No IHT saving (Reservation of Benefit through continued occupation).

In fact, potential double IHT if a child dies with them, in respect of that child's share of the property.

Loss of CGT exemption for the house.

No CGT value uplift to date of death.

No security, especially if a child dies and an in-law or minor child becomes entitled to a share.

Don't do it!

Option 2 – Gift followed by full rent**Proposal**

Transfer the ownership of the house to the three children equally by way of gift, whilst Arthur and Angela continue to live there under a formal lease at a full market rent. Each party must be separately advised through separate solicitors and surveyors; the terms of the lease must be negotiable upon commercial terms. Arthur and Angela may need to protect their future care needs.

Good Results

Takes the whole value of the house out of the IHT net after 7 years.

Security of tenure through the lease.

Future care needs covered.

No POAT.

Bad Results

Loss of freeholder status, becoming a tenant instead.

Bad news for income, unworkable for Arthur and Angela since their investment income is less than the rent would be, and they would be destitute. [This does, however, work well for people with large pensions; the rent they pay further reduces their estates.]

The rent is taxable income for the recipients.

Loss of CGT exemption for the house.

No CGT value uplift to date of death.

Option 3 – Lease back coupled with sale to children**Proposal**

Arthur and Angela sell the house to their adult children on terms that they will take a peppercorn (or nominal rent) lease back in their own favour, the price they achieve being discounted to take account of the lease. Each party must be separately advised through separate solicitors and surveyors; the terms of the lease must be negotiable upon commercial terms. The children must finance the purchase from their own resources or by commercial "buy-to-let" mortgage. Arthur and Angela subsequently, some time later, could give away some or all of the proceeds of the sale. There cannot be any such "understanding" or agreement in advance. Arthur and Angela may need to protect their future care needs.

Good Results

Takes out of the IHT net:
 the amount of the discount straight away
 the whole value of the amount gifted from the proceeds of the sale, 7 years afterwards.
 Security of tenure through the lease.
 Future care needs covered.
 No POAT.

Bad Results

Loss of freeholder status, becoming a tenant instead.
 Loss of CGT exemption for the house.
 No CGT value uplift to date of death.

Option 4 – Gift of a share to a child, who occupies the house with Arthur and Angela

Proposal

Transfer a proportionate share of the value of the house to one of the children, who comes to live with Arthur and Angela. Arthur and Angela must continue to pay at least their retained proportion of all expenses of the house, but no rent.

Good Results

Takes the gifted proportion of the value of the house out of the IHT net after 7 years.
 Security of tenure through ownership of the retained share.
 No loss of CGT exemption.
 No POAT.

Bad Results

Causes imbalance between the three children, and potential family friction.
 If the child later leaves, IHT reservation of benefit starts unless Arthur and Angela then start paying full rent. However, that means still no POAT.
 No CGT value uplift to date of death.

Option 5 – Lease carve-out 7 year gift

Proposal

Arthur and Angela take a lease back in their own favour (through intermediate nominees), at a peppercorn rent. They also retain the freehold until 7 years have elapsed; they then gift the freehold to the children.

Good Results

Takes the value of the freehold title to the house out of the IHT net after 14 years. No reservation of benefit problem.
 Security of tenure through the lease.

Bad Results

Loss of freeholder status, becoming a tenant instead.
 Loss of CGT exemption after 7 years.
 No CGT value uplift to date of death.
 POAT will be payable. Need to compare potential total POAT payable against IHT likely to be saved.

Option 6 – Reversionary lease

Proposal

Arthur and Angela grant a 125 year ground rent lease to the children, to commence on death of both Arthur and Angela or within 21 years if sooner. They retain the freehold, the value of which will diminish, down to a minimal value at the point the lease commences. The leasehold value will by then be almost equal to the normal freehold value.

Good Results

Takes the value of the freehold value of the house out of the IHT because of the shifting of value to the leasehold.
 Security of tenure through continued ownership of the freehold.

Bad Results

Loss of CGT exemption on the increasingly valuable leasehold interest.
 No CGT value uplift on the increasingly valuable leasehold interest, to date of death.
 POAT will be payable. Need to compare potential total POAT payable against IHT likely to be saved.

Option 7 – Spouse sales

Proposal

Arthur and Angela each sell their half share of the house to the other one. Neither of them pays a cash price, instead Arthur and Angela receive an IOU from each other. Arthur and Angela then give their IOUs to the children.

Good Results

Takes the full current value of the house out of the IHT net after 7 years (future growth in value of the house remains in the IHT net).
 Security of tenure through the half share each has bought from the other.
 No loss of CGT exemption.
 Full CGT value uplift to date of death.
 No POAT.

Bad Results

Stamp Duty Land Tax payable on the sale. This will usually add 4% to the overall cost, and make the scheme too expensive for most.

Problems if there has been any previous property transfer between spouses.
 Seen as aggressive by Revenue.

Option 8 – Downgrade and move to a smaller property

Proposal

Arthur and Angela sell their house and move to a smaller property, which is valued less. Followed by cash gifts.

Good Results

Value of the property in their estate is less although the value of their estates for IHT purposes is not reduced by the sale.
 Value of the amount gifted taken out of the IHT net 7 years afterwards.
 Security of Tenure in the new house.
 CGT exemption for the new house.
 Future care needs possibly covered in a retained (smaller) house.
 No POAT.

Bad Results

Arthur and Angela may wish to continue living in their family home for sentimental reasons.
 Costs relating to the sale and purchase e.g. legal fees, disbursements, Stamp Duty Land Tax etc.
 The physical move.

Option 9 - Life assurance related schemes and Annuities

There are some schemes promoted by life offices, regulated by the Financial Services Authority. Mundays does not offer them, but can recommend financial advisers who do.

Option 10 – Commercial arms length Equity Release Schemes

Proposal

Arthur and Angela release equity in the house via an equity release mortgage and receive a cash lump sum. This could be followed by cash gifts.

Good Results

Value of the amount(s) gifted taken out of the IHT net 7 years afterwards.
 Security of Tenure.
 CGT exemption for the house available.
 Future care needs remain covered.
 No POAT.

Bad Results

Depends on the terms of the provider. Could be more favourable to the provider in the long-term; the debt can mount up very quickly.

Option 11 – Take out a normal (non-equity release) mortgage

Proposal

Arthur and Angela could reduce the value of the property in their estates by taking out a mortgage. The mortgage proceeds could be followed by cash gifts.

Good Results

The amount of the mortgage on death is a liability of their combined estates and reduces the IHT payable.

Value of the amount gifted taken out of the IHT net 7 years afterwards.

Security of Tenure.

CGT exemption for the house available.

Future care needs probably still covered.

No POAT.

Bad Results

The mortgage has to be paid off. Cash flow issue depends on the terms of the mortgage and available income after income tax.




Health Warning

Schemes involving your house are aggressive forms of tax planning, and some are more likely than others to be attacked by the Revenue in test cases in the future. They have to be set up using very carefully drafted documentation, and only after a full review of the family and tax situation. It is now apparent that they may be attacked retrospectively. Getting it wrong can damage your wealth, and indeed your health.

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