Property Tax: Your Choice

If you own an investment property there are several good reasons why you may wish to pass it to the next generation. The most obvious of these is as part of a plan to reduce your exposure to inheritance tax. Any gift of property you make results in your taxable estate, on your ultimate demise, being that much less and potentially saving 40% of your wealth for your family to enjoy. Alternatively, you may not need the rental income and you may be thinking income tax and wanting to take advantage of the lower tax rates that the children may have.

All this is potentially sound planning in principle but the problem standing in your way is invariably capital gains tax. When you give away a chargeable asset like property, the tax rules ensure that your gift is treated in exactly the same manner as if you had sold it at current market value. Consider two neighbours, Mrs A and Mrs B, each having an investment property which they have owned for many years. Each property is currently worth £300,000 and each was acquired for £50,000. Both find that their income is sufficient without receiving the rental income and each wishes to gift the property to their respective children.

Mrs A considers gifting the property to her children absolutely but learns that she faces a capital gains tax bill of up to £70,000. This imposition must draw on her vital cash savings which is not an attractive prospect. She procrastinates and eventually does nothing. Mrs A dies 10 years later and although property prices have remained flat, her estate suffers £120,000 inheritance tax on this property alone, leaving a mere £180,000 for the family who may be forced to consider a sale to fund the tax liability. Any growth in the value of the property would increase the tax payable of course and, in the meantime, she has suffered income tax on rentals she didn't really require.

Mrs B is in exactly the same position and would not make the gift if it meant liquidating her other investments and suffering yet more capital gains tax on these disposals. Unlike Mrs A, she goes ahead but, after taking advice, does not give the property directly to her children. She transfers it to a straightforward trust with her children as beneficiaries. Unlike the case with the absolute gift, capital gains tax holdover relief is available with the consequence that there is no tax at all to pay on the gift and the children, as beneficiaries of the trust, take over the property at its original base cost of £50,000. She dies 10 years later and the property suffers no inheritance tax charge as it is no longer in her estate.

Fortunately for Mrs B the value of her property is within her inheritance tax free 'nil rate band' of £325,000. Above this, and the transfer to the trust would encounter a lifetime inheritance tax charge at 20% on any excess. Another disincentive to action but one which is not necessarily a problem. If Mrs B has a husband that limit can potentially be doubled to £650,000 or even to £662,000 if this and last years annual exemptions are unused by both spouses.

That ceiling can be pushed as high as £1 million without a significant tax charge with properly considered planning and depending on Mrs B's precise circumstances. Indeed, even if Mrs B had needed to retain access to the rental income then there is a perfectly legitimate way to achieve this without the property remaining in her estate for inheritance tax purposes.

Given that in practice property portfolio’s represent the most common asset class which is hammered by inheritance tax every year, an immediate charge to capital gains tax is very rarely an adequate reason for doing nothing when it can be deftly side-stepped by anyone in Mrs B’s position.

This article was written by Stephen Parnham for the Professional Panel- 3rd December 2011