# INVESTMENT PROPERTY AND INHERITANCE TAX

**Many people over the last few years have invested in rental properties, sometimes referred to as “buy-to-lets”. However, although they may be a good way of producing income during your lifetime, or indeed capital appreciation, many people have not considered, however, the inheritance tax implications of owning investment properties or the possibility of restructuring the way that the properties are either purchased in the first place or, once a person holds a portfolio of properties how to restructure that so as to be able to pass that on to the next generation in a more tax effective manner.**

If a person owns an investment property it would be treated as part of his estate and in the event of death would be subject to 40 per cent inheritance tax. Often when a person has already purchased a property and that property has gone up in value it becomes even more difficult to plan for the next generation because of capital gains tax. If one was to make a gift of the property that will, in all likelihood, trigger a hefty capital gains tax liability and on property that could be at the rate of 28 per cent. Obviously, everybody’s situation is different and therefore the solution will be different.

Here at Mackrell.Solicitors all that we do is tailor-made for the individual client. We look at each person’s individual circumstances before suggesting a tax solution which would best fit their needs and goals.

**Let us look at three case studies.**

## 1

Mr and Mrs Smith have just inherited some £600,000 from Mr Smith’s father’s estate. They also have a further £200,000 in savings. They would like to invest that in buying a new property for rent. If they buy it in their own name and keep it within their estates that is likely to be chargeable to 40 per cent inheritance tax in the event of death. The rental income is simply going to add to their own income and that could well push them in to the higher rate bracket of 40 per cent. If they were to retain the asset for a short period and it goes up in value and then decided to gift it to their children that is likely to incur capital gains tax.

In that scenario, they should consider setting up a new company and making a loan in to that company of £800,000. They would have agreed terms as to repayment of that directors loan. In effect, because the company will be paying them capital in their hands that would not be subject to income tax. Obviously there are certain conditions which must be complied with.

The company purchases the property, although there may be a higher rate of stamp duty payable overall the saving will far outweigh that. They would have, in any event, had to pay the SDLT surcharge as it is a second home. They can then gift the shares in that company to the children or in to a trust for the children. Thus, the value of the property would be held by the children and not in their estates. The company pays corporation tax on the rent at a rate of between 19 per cent and 25 per cent, depending on the company’s profitability, for the majority of companies it will still be at the lower rate. Even at 25 per cent it is still considerably lower than the personal individual rate. They receive “income” in the form of directors loan. Eventually, once that loan has been paid off there will be no inheritance tax in respect of this property in their estates. They could even, sometime later in life, make a gift of that loan to the children and provided they survive seven years that would become free from inheritance tax. A simple but effective solution.

## 2

Mr and Mrs Green own a property company which owns several properties worth in the region of £5,000,000. They receive the rent from those properties. If they make gifts out of the rent which does not affect their standard of living those gifts are treated as normal expenditure out of income and free of inheritance tax, no matter what the level is. There are certain conditions that they have to comply with, such as it must be shown to be a pattern of giving but nonetheless this could reduce their inheritance tax but it will make very little dent in the capital value that they have of £5,000,000. Ignoring for these purposes any tax threshold 40 per cent on £5,000,000 means that when Mr and Mrs Green pass away their children will have to fund an inheritance tax bill of £2,000,000. One way of reducing this is for them to create different classes of shares within the company. Basically, one class of shares will have the value up to the current value of the company and the second class will be in respect of any values above that so that if a distribution is made, let's say when the company reached £6,000,000, the increase in value would belong to the B shares and the £5,000,000 would belong to the A shares. They gift away those B shares to the children now when they are worth very little, since they have very negligible value until the company grows. There is therefore no capital gains on them. The future growth is therefore held within the children's estates. This means that if in 10 or 15 years' time the value of the properties double in price to £10,000,000, instead of having to pay an inheritance tax bill of £4,000,000 that is practically halved. They could even try to reduce that further, for example, in their respective Wills they leave each other their shares in the company and then the survivor, after a period of two years, makes a gift of those shares to the children. Provided he or she survives seven years that becomes free of inheritance tax. Because death uplifts the value of the company shares there would be a new base value for capital gains tax purposes as well. They could also consider taking out an insurance policy for the seven year period.

## 3

Mr and Mrs Wright have built up in their own names a sizeable portfolio of buy-to-let properties and let us say that once again they are worth approximately £5,000,000. If they were to start to transfer those properties in to a company that would be subject to stamp duty. If they were to gift it to the children in their lifetimes that would become subject to capital gains tax and if they were to simply leave it to the children on death then that would be subject to the 40 per cent inheritance tax. If, however, they were to create a new family limited liability partnership they could transfer those assets in to the limited liability partnership, which is treated as tax transparent for income tax and capital gains tax purposes. If they then run the LLP as a management business as opposed to an investment business (and this will obviously depend on all the circumstances) they could then, after they have done this for a couple of years, consider incorporation and using the holdover relief provisions for capital gains tax on that they would have the flexibility, as mentioned above in case number 2. Alternatively, depending on all the circumstances, they could amend the partnership deed so that the capital is distributed to the children and after seven years this becomes free of IHT. They would claim holdover relief for capital gains tax purposes, provided of course that this is a management trade and not a pure investment. It is important therefore that they would have to have a sufficient number of buy-to-lets that one could say it is a management trade as opposed to holding one or two properties, which clearly would be treated as a mere investment.

## 4

Mr and Mrs Holt hold an investment property valued at £500,000. They use the rental income to supplement their pensions. If they were to simply give away the property to their children besides the question of any capital gains tax applying they would also have to worry about losing the income. If, however, they were to create a long lease of the property and grant that to a trust but postponed for a number of years. The lease will be for, say, a period of 150 years so that in effect it is going to be valued at more or less the same value as the freehold. As far as capital gains tax goes, if they put that in to a trust provided that between the two of them they do not put in more than £650,000 (the inheritance tax threshold) they will be able to holdover any gain. There will be a gain where a lease is granted for no consideration, i.e. it is a simple straightforward gift, it is not a commercial transaction. The postponement can be for the relative life span of Mr and Mrs Holt. Let us say they decide that they want to continue to receive the income for the next five years. They would therefore grant the lease of 150 years to the trust, postponed for a period of five years. In other words during that five year period they retain the rental income. After the five years the postponement comes to an end and the rental income then goes in to the trust. The longer the postponement the greater the value they will still retain in their hands. They do still need to survive seven years after the postponement so that the value then becomes totally free of inheritance tax. This solution is very useful for a person who only has a couple of properties, which are investment properties, but wish to retain some of the income from it. Care must also be taken on the valuations because of the capital gains tax position.

These are just a few examples of cases that we have dealt with which have been successful in reducing the inheritance tax in respect of such investment properties and enabling our clients to pass on their wealth to the next generation.


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