Investment Property and Inheritance Tax

Overview

Investing in property has, over the years, been one of the best ways of generating both income and capital and ever since the 1980s more people than ever have chosen to buy second, third or even multiple residential or, to a lesser extent, commercial properties as a way of boosting their financial worth.

Whilst this has seen many people significantly grow their net worth, few if any have taken any proper professional advice as to the longer term consequences regarding capital taxes such as Capital Gains Tax (CGT) and Inheritance Tax (IHT). In which regard, other than gifts to one's spouse or civil partner, IHT is levied at 40% on one's worldwide assets on everything above £325,000. Given that the vast majority of investment property owners have purchased the assets in their own names, resulting in the asset value directly falling in to their personal estate for IHT purposes, then it's not difficult to see why HMRC could well end up being your second biggest beneficiary when you die.

If, however, your investment properties are owned by a dedicated investment company with its shares held via a Family Trust, it then becomes possible to significantly reduce if not completely remove the IHT liability. Of course, one can just as easily give the assets away during one's lifetime but it will take seven years before the capital value becomes IHT free, the gift has to be absolute (which means that you can't receive any income or capital from it), it will count as a disposal for CGT purposes and, if the value is more than the then Nil Rate Band (NRB) (currently £325,000), a chargeable lifetime transfer occurs leading to an immediate, recurring (every ten tears) and exit IHT charges. Moreover, all the gift has achieved is to create a similar problem in the recipient's estate.

On the other hand, if properties are acquired through an investment company, it is possible to pass on shares in the company much more tax efficiently, especially as Corporation Tax is currently lower than CGT. However, the same gains will be reflected in an increase in the value of the shareholdings in the company, so that at disposal there may be a double liability to tax on the appreciation in value of the underlying properties. That said, with a family property company this drawback may be more apparent than real as only actual disposals are liable to tax, so that long term retention attracts no tax on increasing values. Very often, the company will remain on a semi-permanent basis as an investment holding vehicle with no intention to liquidate or sell it to a third party.

One of the key reasons why using a company is particularly tax efficient is that the total value of all the various shareholdings are often substantially less than the full asset value of the company. In particular, it is usual for the company's Articles of Association to place restrictions on the transfer of shares to protect the company's founders, or its controlling group, from the dangers of shares passing into the hands of unwelcome third parties. The effect of these restrictions, combined with various Companies Act rules on when the shareholders may pass ordinary or special resolutions, means that shareholdings are often valued at a substantial discount when compared to their full asset value. That said, the discount is usually a matter for expert negotiation with HMRC's Shares and Assets Valuation Section, but it could be as much as between 50% and 75% for the larger holdings, whereas the small ones, those say between 26% and 50% of total share capital benefit from a lower discount somewhere between 25% and 50%. In addition, shareholdings or 25% or less are often valued at an even larger discount when compared to their full asset value.

Thus, if the shareholdings can be fragmented around family members or family trusts, it is possible to benefit from substantial discounts on asset value for tax purposes so that much of the value in the company entirely escapes the capital tax system. However, achieving this fragmentation can sometimes incur tax charges and requires detailed knowledge of the complex tax rules.

Forming the company

In an ideal world, a property portfolio would be built up from scratch within a company, with new purchases made by the company. However, property investment usually starts in a small way with personal acquisitions by one individual, with the portfolio gradually built up thereafter.

The above notwithstanding, if there have been increases in the property values; it may be that a transfer of ownership into a company incurs a tax liability, as the transfer represents a disposal for CGT purposes. Although under normal circumstances there is CGT incorporation relief, HMRC tends to take the view that property investment is outside the scope of that relief resulting in crystallisation of a CGT charge. In addition, the transfer of properties will give require paying stamp duty and conveyancing fees.

Because of these tax liabilities, one strategy which may be considered is for a property portfolio to be left on the death of the property owner to his or her surviving spouse who can then transfer them to a newly formed company with only stamp duty land tax then being payable. Gains on all personal assets are eliminated on death when new probate value base costs are established; thus, a transfer to a company shortly after the properties have been inherited may not incur a CGT liability.

Existing property companies

If you already have a property company, it may be possible to transfer the shares without incurring either CGT or IHT. However, given the complexity of the rules and the variability of each individual circumstance, it is not possible to give specific advice in this fact sheet.

That said, in general terms and provided that the loss in the donor's estate does not exceed the Nil Rate Band (NRB), currently £325,000, there may be no immediate charge to IHT although the gift will be classed as a Potentially Exempt Transfer (PET) and subject to the seven year rule; being that the donor has to survive for seven whole years before the gift finally drops out of their taxable estate.

You should please note that this fact sheet is for general information only and is based on our understanding of current taxation, legislation and HM Revenue & Customs practice as at April 2013, all of which are liable to change without notice. The impact of taxation (and any tax reliefs) will depend upon your individual circumstances and you should contact us before taking any action.

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