Mercer & Hole | Property

Introduction

After years of significant rises in property prices, we have seen a downward trend in recent times in the market. This may be particularly felt in London where the decrease is reportedly worse than in some other parts of the country. Many factors may have contributed to this not least changes to tax legislation including the rise is stamp duty land tax (an additional 3%) on second homes. Following the recent interest rate rise comes further speculation that UK property may decline further.

Despite this, the fact remains that UK property remains unaffordable for many young adults without some financial assistance, often from their parents. Taking first steps onto the property ladder can therefore be a difficult task and clients want to understand how they can best help their children both from a practical and UK tax efficient perspective. I evaluate a number of options that arise in practice in my article 'Buying property for children'.

It is also not uncommon for people to rent out a spare room in their house for various reasons. Subject to the conditions, rent a room relief has been a tax efficient and simple solution for many people enabling them to receive a tax free sum without an onerous administrative burden. With the advent of Airbnb and other similar sites, renting out a room has become ever more popular which has instigated a review by HMRC of the way in which the relief will apply. Cathy Corns looks at the new rules and what this will mean in practice.

For those who already own UK property, preserving its overall value for the next generation is often a key objective. Henry Lowe considers an aspect of inheritance tax planning and how additional wealth can be passed on with the benefit of the main residence nil rate band, where it is available.

Finally, HMRC persist in bringing non UK resident landlords of UK property in line with the position for UK resident landlords. Gains on disposal of UK commercial property will be brought into charge to tax in the UK from April 2019. Looking further ahead, non UK resident companies will be brought into the scope of UK corporation tax on their UK rental profits from 6 April 2020. Alison Palmer provides an overview of how these changes are expected to apply in practice.

Looking ahead, we will keep you advised of the key topics we are encountering regarding the property market. In the meantime, I hope we have provided you with some interesting food for thought. If there is anything within these pages that resonates with you and you would like to discuss personally, please do get in touch with me or my colleagues. We will be very happy to help you.

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Buying property for the children

Parents often want to help their children buy a first property but that is sometimes mixed with concern about the potential risk of losing some of the family wealth - for example, if the child enters a relationship that fails with the risk that some assets are shared with the partner. For the purposes of this article, the child is aged 18 or over.

Below, I have highlighted some of the options that can be considered. All have their merits for different reasons. In practice, the objective to preserve wealth long term often trumps some of the tax considerations when it comes to deciding just what to do.

Gift of cash sum to child

Parents can make a simple unconditional gift of cash to the child to enable the child to have a sufficient deposit or full funding to buy the property. The child would be the sole owner and the acquisition is funded with the cash plus a commercial bank loan, if required.

This is simple and transparent. There are additionally some Inheritance Tax (IHT) benefits to be obtained by this strategy, subject to certain conditions being met:

Potentially Exempt Transfer (PET)

The gift is a PET and falls out of the parent's estate for UK Inheritance Tax (IHT) purposes in full after seven years have passed from the date of the gift. The parents must not receive a benefit out of the sum given away and the parent's estate then saves IHT at 40% on the value of the gift after the full seven years.

Capital Gains Tax (CGT)

Assuming the child occupies the property as his or her main residence, throughout the child's period of ownership, any capital gain arising on disposal of the property will be exempted from CGT by Principal Private Residence Relief (PPR). Periods of ownership not occupied by the owner will not be exempted, although further reliefs, not covered here, may be available.

The key disadvantage is the outright control and ownership it gives the child. If the child enters a relationship that later breaks down, there is a risk of assets being lost to the estranged partner. Outright ownership also gives the child power to sell the asset whenever he or she wishes. It is this aspect that has the potential to be the subject of conflict on a practical level.

Joint Ownership

If a property is partly owned by the parents and partly owned by the child, then in the event of a relationship breakdown for the child, the part owned by the parent or parents is likely to be protected, assuming the property was acquired well in advance of the relationship breakdown.

Also, a property owned by more than one person can only be sold by agreement of all owners. Therefore, if the parents own an interest in the property and the child owns the remainder, the child cannot single-handedly sell or mortgage the whole property.

The drawback is the absence of PPR relief in relation to the part owned by the parent. Any gain arising on a disposal of the parents' interest during their lifetime will therefore attract CGT at 28% (at current rates).

Although not covered by this article, the Stamp Duty Land Tax (SDLT) implications of parents acquiring an interest in a second property must also be considered when assessing the assets involved.

Due to the SDLT complications, joint ownership is sometimes approached by way of the parents making just a loan to the child and taking a charge over the property rather than anything else. This is simple to achieve and ensures the parents get their money back in the long run.

However, the cost of protecting the parents' wealth like this is continued IHT exposure for them. The property interest owned by the parents or the loan receivable by them is still part of the parents' own estate for IHT purposes and will attract IHT at 40% on their deaths without further planning.

Acquisition by a family trust

A family trust may already exist in which case it is worth considering acquisition of the property by that vehicle, if the trustees have sufficient cash to fund it. Trustees usually find it more difficult to obtain commercial bank mortgages and so in practice, this option works best where the trustees can buy the asset outright with cash they already have. The trust I refer to here is a UK trust, of which the settlor is specifically excluded and trustees have discretionary powers over all beneficiaries.

If there is not an existing trust, the parents could create a trust by each making a life time transfer of £325,000 (£650,000 in total) to a trust to fund it, subject to not having made transfers in the previous seven years. The sums transferred are chargeable lifetime transfers and therefore, if the parents transfer more than their nil rate bands for IHT, the excess would be subject to an IHT charge of 20% at the time of transfer.

If the property cost more than the total sums transferred, then it is better to transfer the balance by way of loan, if the parents have the cash available to do so. A loan is not a chargeable transfer but must be properly legally documented with repayment terms.

The big advantage of a trust is that it is a completely separate vehicle enabling family wealth to be ring-fenced and protected. This is extremely helpful in alleviating some of the concerns described with direct ownership over outright control.

In this respect, a trust can provide the best of both worlds - the trustees can allow the child to occupy the property and even pay all property maintenance costs for him or her but the child neither owns nor has direct control of the property.

Provided the settlor(s) are specifically excluded from benefit, trust property is also not part of the beneficiaries' own estates for IHT purposes. It belongs to the trustees and there are IHT consequences for them.

The trustees are subject to a charge to IHT on every 10th anniversary of the trust in respect of their chargeable relevant property. This is the '10-year charge' that, very broadly, amounts to 6% of the value of chargeable trust assets held on that occasion.

However, this is nowhere near the IHT rate of 40% on death if the property is held in a person's own estate but it does accelerate a tax charge at a time when there may otherwise not have been a charge at all.

If the trustees ever decide to appoint the property out to a beneficiary, an IHT exit charge arises on the trustees as property is leaving the trust. The actual calculation can be complex, but the rate charged does not exceed 6% at an absolute maximum and is often much less than this.

The trustees are also likely to qualify for PPR exemption as long as they grant the beneficiary a right to occupy the property and they do so as their main residence for the entire period of ownership. Given that trusts are used for asset protection, appointment of the asset is not usually on the agenda, at least in the short or medium term.

Longer term, there could potentially be other taxes to consider. For example, if the property is put to another use, such as being let out by the trustees, the trustees will pay income tax on the rental profits at the highest rate of income tax, currently 45% and CGT on any chargeable gain arising in the year of disposal is charged at 28%.

With all this in mind, for family trustees who can afford to fund a property acquisition, it is important to understand the short- and long-term objectives for the property before embarking on this strategy. For cases where it is appropriate, the trust can work very well indeed.

> *A trust can provide the best of both worlds - the trustees can allow the child to occupy the property and even pay all property maintenance costs for him or her but the child neither owns nor has direct control of the property.*

Acquisition by a family investment company

It is widely regarded that ownership by a company of residential property for one's occupation is unattractive if considered solely from a tax perspective. This is essentially because a company owning a UK residential property is subject to the Annual Tax on an Enveloped Dwelling (ATED), a charge which is set in line with the valuation bandings for the property.

In a nutshell, all residential property worth more than £500,000 at 1 April 2017 is subject to an annual charge starting at £3,600 for 2018/19, which this goes up to £226,950 for properties worth more than £20m. The SDLT payable by a company acquiring a UK residential property worth more than £500,000 for occupation is generally punitive at the rate of 15% and on top of this, the individual in occupation will have a benefit-in-kind charge on the benefit of rent-free occupation.

However, there is relief from the ATED charge where a property is rented out on arm's length terms to an unconnected third party. Companies also pay corporation tax on their rental profits, which is lower than the current rates of income tax - the rate of corporation tax is currently 19% and will be reduced to 17% from April 2020.

For IHT purposes, each shareholder has IHT exposure only in relation to their shareholding in the company and the value for minority shareholders can carry a discount so exposure to IHT on the overall company value can result in being favourably split across family members.

Despite these potentially positive points, considering all of the above, unless the property is modest in value and likely to be rented out, this option is not going to be as attractive as some of the others but ought not to be dismissed without due consideration.

What is best?

There is no single answer and the most appropriate solution will depend on the overall family circumstances and willingness to accept the particular tax costs attached to the chosen solution.

Asset protection will best be met with a trust and the tax costs are probably manageable.

Relatively speaking, the 6% IHT anniversary charge is modest and much better than 40% on death if held personally.

CGT relief is available provided the beneficiary occupies it so is the same as if it were held personally. There may be more SDLT to pay on acquisition by a trust than directly by the child and there will also be some administration costs associated with running the trust.

With high property prices, the cost of making a bad choice is going to hit hard. Some tax charges arise and operating costs arise for the trustees but in the end these are a financial expectation and necessity to protect big family wealth.

Funding a trust to a level that can meet the financial cost of property acquisition will take time so early planning is essential and full advice should always be sought in advance.

Options in brief

Detailed below is a brief summary comparison of the taxes under the options outlined in this article:

Personal ownership - child and/or parent	
IHT	Yes, 40% on death in the individual owner's estate
CGT	Yes, 28% unless PPR relief exempts whole or part of the gain
Income Tax	Yes, if property is later rented out and gives rise to rental profits IT is charged at individual's marginal personal tax rate. Tax rates 20%, 40% or 45%
SDLT	Yes (rates vary)

Trust Ownership	
IHT	Yes, for trustees 10 year and exit charges, but maximum rate of 6%. No 40% rate
CGT	Yes, same as above, 28% unless PPR exempts whole or part of gain
Income Tax	Trustees pay income tax at 45% on rental profits
SDLT	Yes (rates vary)

Family investment company	
IHT	Yes, 40% on value of company shares held by shareholder at individual's death
CGT	No
Corporation Tax	Gains taxed within company profits. CT rate is currently 19%
Income Tax	Yes (rates vary)
SDLT	Yes 15% if property worth more than £500,000 and rates vary

If you would like to discuss this subject in relation to your own circumstances, please do get in touch.

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Main residence nil-rate band reminder

The ability to pass on additional wealth to younger generations free of inheritance tax (IHT) is forefront of mind for many of our clients.

The good news is that from 6 April 2018, the new main residence nil-rate band (rnrb) legislation provides an improved position for IHT planning. In certain circumstances, this determines an extra £125,000 of relief is available on death. Below, I provide a reminder of the qualification criteria for the relief and how it applies.

The standard IHT nil-rate band is £325,000 per individual but currently this can be enhanced by a further £125,000 main RNRB, where a person's home is included in the death estate and is passed to a lineal descendant, such as a child or grandchild.

The relief is gradually increasing and the maximum annual allowances are:

RNRB	Year
£100,000	2017/18
£125,000	2018/19
£150,000	2019/20
£175,000	2020/21

Where the value of the death estate exceeds £2 million, the available RNRB is tapered by £1 for every £2 above this threshold.

Similarly to the standard nil-rate band, any proportion of unused RNRB can be transferred to a spouse, currently providing up to £250,000 (£125,000 x 2) of IHT relief on the second death.

The interest in the property being passed on must have been the residence of the donor during their period of ownership. In the event that an individual downsizes and moves to a lower value property prior to their death, rules exist to allow relief in reference to the value of the former more valuable property.

There is no requirement for the recipient of the property to retain ownership.

It is important that individuals review their situation and their current wills to preserve their eligibility and make best use of this relief, with property passing to qualifying recipients. In the event this has not taken place, certain steps can be taken after death, to vary the terms of a will, to maximise the relief.

If you would like to discuss this subject in relation to your own circumstances, please do get in touch.

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Non-resident company owners of UK property

The past few years have brought multiple changes to UK tax law applicable to owners of UK property. many of the changes have been targeted at overseas holders of UK residential property many of whom occupy them occasionally only or not at all.

Capital Gains Tax (CGT)

We have already seen the introduction of CGT on disposal by non-residents of UK residential property. The most recent raft of draft legislation more widely applies CGT and was published in July. It seeks to do the following:

- Extend the scope of tax for non UK residents to include commercial property.
- Charge CGT on residential property disposals by diversely held companies, widely held funds and life assurance companies, all of which were not previously caught.
- Tax non UK residents on gains they realise from disposals of interests in UK property rich entities (such as shares in companies which derive 75% or more of their value from UK land). HMRC promises to counteract attempts to manipulate the threshold. There will, however, be an exemption for businesses who use the property in their trade and also for qualifying investors whose interest (together with certain connected parties) is less than 25% throughout the two year period leading up to the sale.

The overall policy objective is to level the playing field between UK and non UK resident vendors of UK property. The above legislation will apply to disposals made on or after 6 April 2019 and anti-forestalling and targeted anti avoidance rules will seek to catch arrangements which attempt to circumvent the new provisions. The implications of Double Taxation Treaties in conjunction with the new rules may need to be considered where indirect disposals are being made, depending on the circumstances.

There are some sweeteners: Vendors who come into the charge to tax under the new rules will have the ability to rebase their asset base costs at 5 April 2019 which will ease the transition. Additionally, non UK companies who become UK resident after 5 April 2019 will be permitted to retain the rebasing for subsequent sales.

The new rules will however, be disapplied to vendors who cease UK residence after 5 April 2019 in some circumstances. Relief for losses may also be limited with the rules following those for UK resident companies and non-resident CGT as appropriate.

Special rules will apply to collective investment vehicles and exempt entities which invest in UK property.

Corporation Tax

There is some good news: There is draft legislation to charge all non UK resident companies, including close companies to corporation tax rather than CGT on gains they realise on the disposal of UK property from April 2020.

Whilst this will bring yet further change as far as compliance and reporting is concerned, the rate of corporation tax in the UK is set to be 17% from 6 April 2020 and so this should lower the overall tax burden on non UK resident profits at one level.

At the time of writing the Prime Minister is also looking at introducing a further SDLT charge of 3% on foreign purchases so whether you have or are considering owning UK real property, you should seek early advice so as not to fall foul of the UK's tax rules here.

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Making the most out of your home? Rent a room relief

For years, it has been very common for people to rent out a room in their home for all sorts of reasons and take advantage of rent a room relief.

The owner (landlord) of the property can currently earn up to £7,500 in gross rents per year tax free by renting a room to a lodger provided certain conditions are met. The accommodation must be furnished, situated in the UK and the owner's only or main residence for at least some of the year. The relief does not cover letting as an office, storeroom or garage or to a company or partnership. However, it does cover provision of services such as bed and breakfast.

The maximum relief that can be obtained tax free is £7,500. Importantly this figure refers to gross rents and not net profits. If the limit is exceeded you can elect to reject the relief and be taxed instead on total net rental profits under the normal income and expenditure rules. Alternatively, you can take the relief and be taxed on the excess gross rents over £7,500.

The way the law is currently written, rent a room relief is available in a number of scenarios and includes where you let out your whole home, for example, while you go away on holiday. So, in this situation, the tenant does not need to there at the same time as the landlord. However, this is about to change.

The growth of internet property rental sites such as Airbnb has led to an increased number of people using the relief which has in turn prompted a change in the way the relief will be applied in practice.

Shared occupancy

From April 2019, rent a room relief will be subject to an additional test of shared occupancy. Basically, this means you must be living in the property for at least some of the time that the accommodation is let; letting out the property whilst you are absent will no longer qualify.

The property must be used as sleeping accommodation for you or a member of the family, for a period which overlaps, wholly or partly, with the letting. The test will apply to each letting.

The change is clearly intended to make sure rent a room relief meets the original policy objective: to provide an incentive for the provision of furnished accommodation to lodgers. It will remain a tax efficient and convenient relief where the conditions are met and worth considering. For others, the change may be bad news and further thought may be required.

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