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PASSING DOWN THE PROPERTY PORTFOLIO

Lee Sharpe

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PROPERTY

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About Lee Sharpe

Lee is a creative Chartered Tax Adviser with more than 20 years' experience of advising property investors and family businesses on tax matters.

He is also an experienced tax writer. As well as writing for taxationweb.co.uk and Bloomsbury Professional, Lee is a lead writer for Property Tax Insider (taxinsider.co.uk) and its sister publications. He has written a number of specialist property tax saving reports that are available through the Tax Insider website.

1 Introduction

The idea of inheritance tax, or IHT, commonly evokes a strong reaction.

A typical complaint might go something like this:

"I've already paid 40% tax on this money when I earned it. I could have been irresponsible, had fun and spent it all but I saved it instead; now, even though my savings mean I am less of a burden on the State, I am going to have to pay 40% tax on it all over again. It's so unfair."

Now, this is not an entirely accurate assessment of how IHT works and even if it were, it is certainly not alone in being 'another tax on something taxed once already': we probably pay VAT on our retail purchases out of our taxed income a dozen times a day, and those retailers will in turn likely – hopefully – pay tax on the profits they make, etc., etc.

Even so, the overall sentiment is hard to fault. More than once, I have seen generally rational clients get quite visceral over the idea of IHT. I suspect a good part of that comes from parents wanting to give their children and grandchildren the best possible chances in life*.

IHT is certainly a tax that people love to hate. Hopefully, this report will encourage readers to see IHT in a different light and to recognise the kind of scenarios where IHT can be an issue, and when it can be safely avoided.

The report is intended to help readers understand the main problems facing landlords as property investors from an IHT perspective and how to deal with those problems efficiently if they hope to pass their property wealth down to following generations *relatively* unscathed. While we do briefly cover donations to charity and the like, it is commonly assumed that most veteran landlords will prioritise their children and perhaps grandchildren. We shall primarily be concerned with planning that landlords can sensibly undertake during their lifetime, and that is ***un***likely to be considered unusual or aggressive so as to risk serious challenge by HMRC.

1.1 Assumptions and caveats

We make several assumptions in this report:

- The focus is on landlords as property investors, who hold property for rental income and potential disposal in the medium-to-long term. This differs from property developers, who buy land and property with the purpose of improving their stock and selling on at a profit. Property developers are carrying on a trade, while landlords are carrying on an investment business. This is an important distinction from a tax perspective and relevant for IHT purposes (see business property relief below, for example).
- The landlord will be a 'buy-to-let' (BTL) landlord with at least a few residential properties held personally or perhaps co-owned with others, such as spouses or civil partners, or perhaps siblings, etc. The landlord may also hold commercial property. (IHT does not generally

'care' overmuch about the nature of the property held, although there are some relatively unusual scenarios involving agricultural tenancies, grazing rights, farmhouses, etc.)
- The landlord will be a long-term UK tax resident so that they will either be domiciled in a UK jurisdiction anyway, or 'deemed domicile' in the UK because of their long-term presence here (and they will not be resident for tax purposes in any overseas jurisdiction).
- The property portfolio is in the UK.
- The rates, bands and allowances used are for 2024/25, where they are known at the time of writing but may be superseded by future fiscal events – budgets, autumn statement, etc. We shall use standard UK tax rates and allowances and, unless a particular model or example calls for it, assume that the landlord pays income tax at the 40% higher rate, so will pay CGT at either 28% on residential property disposals or 20% on disposals of commercial property or broadly anything else, that is *not* residential property.
- Where we refer to stamp duty land tax (SDLT), note that SDLT applies only in England and Northern Ireland, while land and buildings transaction tax (LBTT) and land transaction tax (LTT) apply in the devolved territories of Scotland and Wales, respectively. Those regimes share common ancestry, but differ in the detail, so investors should seek professional advisers with the requisite local knowledge.
- The IHT regime as currently applies will continue to apply for the long term. Obviously, the further ahead we look, the more likely that some change in legislation or practice will affect the planning measures that we adopt or discard.
- Specific or 'tailored' IHT planning requires detailed knowledge of the client, their circumstances, their family and their hopes and intentions for those family members, potentially decades into the future. The report talks in broad terms and will hopefully prove useful as a starting point and to give the reader a sense of various possible opportunities that may be available, but **direct IHT advice from a suitably qualified professional is strongly recommended**.

1.2 The landlord's dilemma

As a landlord's portfolio matures, several factors will conspire to make IHT problematic:

1. **Properties will increase in value over a sufficient timeframe** – Obviously, property prices can fluctuate from one month to the next and even experience a significant downturn period but over the last 20 or so years, house prices, for example, have basically quadrupled across the UK.

   Meanwhile, the IHT nil-rate band – the main 'tax-free allowance' for IHT purposes – has held at £325,000 since April 2009, and was scheduled in the 2022 autumn statement to remain there until at least April 2028. We can call this 'fiscal drag', which is a term used to describe where rising incomes, etc., against static thresholds, drag more people into the tax net to pay more tax. We could also call it 'taking the Mickey': the UK Government's total annual IHT receipts have more than trebled in this millennium, and rising

property prices are a key driver.

2. **The landlord's borrowings will usually have fallen away as mortgage capital is repaid** – Most landlords intend to either use 'capital and interest' mortgages, where the loan capital is repaid over the life of the loan or to sell off some of their properties, using those significantly-increased property values to settle the mortgage debt on the remainder of their portfolio. Of course, this is not always the case, and a proportion of landlords set out to progressively leverage their property portfolios to accumulate cash borrowings. This means that the net value of their property portfolio may actually be quite modest – but they may well have other valuable assets as a result of all that extra borrowing. In the absence of such ongoing high borrowings, the net value of their portfolio should continue to rise even when property prices do not.
3. **Net rental profits will also typically tend to rise** – not least because of ever-increasing tenant demand in the market, but also because mortgage interest and related finance costs will generally fall away as the portfolio matures and loan capital is repaid.
4. **The landlord's own private cash consumption will likely also fall overall**, as they will have paid off their own private mortgages and may no longer have to pay for school or university fees, childcare, family holidays or large cars, etc. This is not always the case, of course, as poor health in older age may require extensive (and expensive) treatment and care.

Both (3) and (4) mean that landlords tend to accumulate both property wealth and cash wealth as their portfolio matures.

5. **It is difficult to transfer property wealth without triggering a significant tax penalty** – If we take a simple scenario where a landlord decides to sell their residential property and to give away the net proceeds to their four children, then it will likely have triggered a large CGT liability at as much as 28% of the gain – and while the gain will of course be a lower figure than the sale proceeds, it will nevertheless likely be quite substantial on a property held for the long-term, as per (1) above.

In summary, then, a typical landlord with a mature portfolio will be accumulating property and cash wealth, and increasing IHT exposure with few obvious remedies that do not, in turn, trigger more tax charges.

2 The main principles of inheritance tax

This section is included to ensure that readers are at least passing familiar with the basics of IHT, as may be relevant to a rental property business.

IHT is charged on the value of one's 'estate', essentially assets less liabilities. It is a separate regime from capital gains tax (CGT).

The value of assets comprised in the estate is generally their open market value if sold on the day of death or other disposition (IHTA 1984 s 160).