THE HOME: INHERITANCE TAX AND CAPITAL GAINS TAX TREATMENT ON DEATH SITUATIONS

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(Statutory references are to the Inheritance Tax Act 1984 unless otherwise stated)

THE HOME - TREATMENT ON DEATH

As a general rule this asset is "sacrosanct" and if possible should not be the subject of tax planning but should be given to the surviving spouse absolutely. Nevertheless there are common circumstances where it is wished to reduce IHT by utilising the matrimonial home and four main proposals are set out below:

Background and Proposal 1:

The matrimonial home maybe one of the assets to use to ensure, if possible, each spouse has assets of the value of the nil band, either by placing the asset into the **sole name** of one spouse or into **joint names** as tenants in common depending on circumstances.

As regards the holding of land and buildings in joint names, there are two alternatives, namely a holding as:

- **"joint tenants"** and as
- **"tenants in common"**.

For the former method, the survivor takes absolutely and by operation of law. Hence it is impossible to make testamentary or lifetime dispositions to third parties, subject to the deed of variation procedure. By contrast, in the case of a tenancy in common, disposals of one spouse's/co-owner's shares during lifetime

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or by will are possible, e.g., to children, and hence this method of holding is generally to be recommended as affording greater **flexibility**. In particular, as a tenant in common of part, a co-owner, e.g., a widow, would be entitled to occupy the **whole**. On her death, moreover, her share would be eligible for a discount of between 10% to 15%[2]. There are, however, two main possible **danger areas**, namely:

- the loss on the creation of such an interest would be greater and taxed at that time. For example, father A transfers his house into joint names of himself and son. Before the transfer the house was worth, say, £200,000; afterwards A's half share is worth, say, £90,000. On the consequential loss formula A's transfer of value is £110,000;

- the other co-owner(s) may be able to **force a sale** as the house would be held on **trust for sale**; Law of Property Act 1925 ss.34 and 35. It is possible that this area of the law will be reformed in the foreseeable future. Meanwhile this danger can be reduced by placing the interest of the co-owners in an appropriate trust with dependable trustees, and with these co-owners preferably only having a flexible, revocable life interest.

In cases where the property is in fact held as joint tenants, but in which it would be preferable for it to be held as tenants in common, it is a relatively simple matter to "**sever**" the joint tenancy to make it into a tenancy in common.

If an individual, e.g., a widow, is given any **right/entitlement** to occupy the matrimonial home, this will normally constitute an "interest in possession " so that the same IHT will be payable as if the house had been given outright, unless the interest terminates more than 7 years before such individual's death (i.e., a PET). Accordingly, to avoid this, any such occupation must be informal, e.g., by way of a non-enforceable licence or permission (there should be no gift with reservation problem, because the donor is the deceased who cannot by definition have reserved a benefit)[3].

Sufficient security of tenure is likely to exist in practice if the surviving spouse is an executor or executrix of the will.

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2 See *Dymond Capital Taxes* p 23. 520.

3 See *Sanson v Peay* [1976] 3 All ER 375 and IR Press Release 15.8 1979 - SP 10/1979; and further references below under "Dangerous Arrangements".

If the testator owns the entire home and wishes to leave the bulk to a chargeable party, e.g., son, yet enable widow to occupy without retaining a life interest in the **whole** chargeable on her death, consider giving widow, say, a 25% tenant in common share, 75% to the son. Widow would then be able to occupy the whole by virtue of her 25% tenancy in common; but the trust for sale danger remains. There must not be a bar against son occupying as co-owner, as such bar would give widow an interest in possession in whole. This can be adapted further as follows.

A recommended route: Proposal 1[4]

This situation can satisfactorily be achieved by use of a **flexible life interest in favour of the surviving spouse** (assume husband/testator owns the home, leaving a widow).

The relevant steps would include the following:

- the will establishes a flexible life interest of the whole home in favour of the widow in testator's will;
- after the testator's death the trustees (of whom the widow could possibly be one - but see below) appoint say 75% of the life interest (i.e. income/occupation entitlement) in favour of the children, the trust remaining subject to the wide overriding powers of appointment;
- the widow remains in occupation, although not exclusively, i.e. the children must not be barred from occupying the home as well if they wish. (A professional trustee may wish to be armed with an indemnity from the children).

The advantages of this approach include:

- inter-spouse exemption on husband's death on the **whole** property - s.18;
- the termination of the widow's full life interest in whole or in part, e.g., 75%, is a **PET**;

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4 see also article by James Kessler 'The Principal Private Residence Part I' in *Taxation Practitioner* November 1990.

- the gift with reservation rules should not apply because as a co-owner the widow is by law entitled to occupy the whole and also because the termination is not "a disposal by way of **gift**" under FA 1986 s.102 (for this reason it is somewhat safer if the widow is not a trustee);

- CGT. If the property is sold at any time during the widow's lifetime (or three years thereafter), **full** CGT private residence exemption should be available by virtue of TCGA 1992 s.225 - as the widow is "entitled to occupy it under the terms of the settlement"; and as a co-owner (whether as joint tenant or the recommended tenancy in common) the widow is entitled to occupy the **whole** of the home, even though she is not **solely** entitled to occupy. By virtue of FA 1991 s.94(2) the widow would not necessarily have had to so occupy the home during the 36 months prior to the sale.

Proposal 2:

The testator could provide in his will that the executors should grant, i.e., **carve out, a lease** for a suitable term of years to the widow. The reversion being gifted to others, e.g., the children.

In this context the recent decision of *Ingram v Inland Revenue Commissioners* [1995] STC 564 is of particular relevance. Moreover, the risk of a gift with reservation assessment is much less because the donor is the deceased testator!

Note the following possible problem areas:

- The lease should not be for **life** (that would constitute a settlement).

- **TA 1988 s.35** income tax problems arise if widow gets a capital sum or premium on assignment (which could include a grant of a new lease).[5] This disadvantage may not apply to a surrender.

- The reversioners will have a low CGT base and therefore a high CGT liability on eventual sale.

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5 see TA 1988 s.24(4).

- The Capital Taxes Office may require a condition to be satisfied, namely, that carving out of the lease was a prior independent transaction to the gift of the reversion (it is considered, however, that this argument is fallacious, certainly in accordance with the previous estate duty decisions on which the inheritance tax rules are based). In any case it is more relevant to a lifetime carve out in the context of the *Ingram* decision which was in favour of the tax-payer on this aspect.

Proposal 3:

Grant of life interest by beneficiary under will to widow(er).

Consider the following possibilities:

Testator leaves home (or share of it) and possibly other assets, e.g., shares of residue to "X", e.g. son .....

Son grants his widowed mother a life interest within, say, 3 months after testator's death, with reversion to him on mother's death.

On widow's death, assuming son X survives, no IHT is payable because of the reverter to settlor exemption; **s.54(1), (2) and (3)**. There should be no CGT because on the widow's death the main residence exemption applies; TCGA s.225.

Proposal 4:

If the home is the main asset in the estate of the first spouse to die -say the husband, he could gift the nil band in his will as a monetary legacy to chargeable parties by use of a mini discretionary trust (i.e., so as not to waste the nil band: currently £154,000 x 40% = £61,600). The residue (i.e., in particular the home) is left to the widow. The nil band gift would be satisfied by a charge on the property in favour of the trustees of the mini discretionary trust (who are likely also to be the executor/trustees of the will). That charge could be on favourable terms for the widow, e.g., free of interest and deferred as to payment of the capital, albeit preferably, payable on demand by the trustees. The charge should then be a deduction from the widow's estate on her death and she would have had use and occupation meanwhile. It is important that the trustees should be specifically authorised in the will to allow the charge to be free of interest and to defer calling in the capital (i.e., permitting the payment of the legacy of the discretionary trust to be deferred).

Dangerous Arrangements

- Use of **discretionary trusts** with widow(er) being a beneficiary. The CTO are likely to treat that beneficiary as having an **interest in possession** in the property.[6]

A possible alternative is - **not** to make the widow(er) a beneficiary, i.e., he/she only occupies as **licensee** or by virtue of own ownership of a share in the home. The CTO may resist this, however, and claim that an interest in possession does exist by reason of de facto occupation.

- Home in joint names but a declaration provides that **no sale** can occur without consent of **both** spouses or survivor. The CTO take the view that the effect of this "**veto**" is to give the surviving spouse an **interest in possession** under s.43(2).[7]

To enable a surviving spouse to be in a position to **disclaim** his/her interest in the home effectively for IHT (i.e., not having received any benefit), consider making a gift of the home **conditional** on surviving the testator for the maximum period i.e., six months from the testator's death.

If, following a death, a particular proposal as outlined above has not been utilised, one should always consider adopting a relevant proposal by a Deed of Variation for Inheritance Tax under IHTA 1984 s.142 and for capital gains tax under the Taxation of Chargeable Gains Act 1992 s.62. For CGT one must, however, always remember that following *Marshall v Kerr* [1994] STC 638 it is the beneficiary not the deceased who is the settlor.

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6 see SP10/79.

7 see *Practical Tax Lawyer* 1994 p 18.