Options for IHT planning where clients own buy to let properties + a case study

Synopsis: Where clients have built up a substantial number of buy-to-let (BTL) properties over the years what are the options for inheritance tax (IHT) planning?

Date published: 12.07.2023

Buying property remains a stable investment for some of individuals. Over their lifetime some of them have built up substantial BTL property portfolios. This type of investment provides them with a regular income in the form of rent together with potential for capital growth. This means that clients can be subject to income tax on the rental income and capital gains tax on disposal.

When it comes to advising on IHT planning for clients with substantial BTL portfolios what are the options available?

Generally, the options available are to either gift some of the properties, sell some of the properties or use life cover to fund the IHT liability.

Gifting BTLs - outright gift

If a client makes a gift of a BTL property this counts as a disposal for capital gains tax (CGT) purposes and there will be tax to pay on any gains. The gains will be subject to either 18% or 28% on a gift of a residential property. The issue with this is that, if the gain is large, your client may not have spare cash to pay the CGT liability.

Consideration also ought to be given to the age of your client as CGT, currently, is rebased at the date of death. This means, if your client holds onto their BTL property, the gain will be wiped out on death. Although this does not help where IHT is also payable on the estate.

A gift to an individual will be a potentially exempt transfer (PET) for IHT purposes and start the seven-year clock.

Gifting BTLs - discretionary trust

Your client may give consideration to gifting the BTL into a discretionary trust instead of directly to an individual. Where a transfer creates a chargeable lifetime transfer (CLT) the gain, in some instances, can be rolled over into the trust. This is called holdover relief and applies where the trust created is NOT settlor interested.

An "interest" in the trust means that trust property can be paid or applied for the benefit of the settlor or their spouse/civil partner or minor child (under 18).

The issue here is that property values tend to be large and, where a discretionary trust is created with an asset in excess of the settlor's £325,000 cumulation, an IHT entry charge will apply on the set up of the trust. A discretionary trust is also subject to ongoing IHT charges, i.e. the periodic charge at every tenth anniversary with potential exit charges applying. They may find that the growth in the property will tip the trust into the realms of the periodic charge.

Any rental income will be payable to the trustees of the trust and be subject to a rate of 45%. Generally, in order to be IHT effective, the settlor cannot benefit in any way from the trust fund. Therefore, they will lose the income associated with the rental property.

Selling BTLs

Another option open to your clients is for them to sell the BTL and do IHT planning with the proceeds. However, the sale, will trigger a disposal for CGT purposes with potential tax being paid over the annual exempt amount (AEA) of either 18% or 28%.

Your client may decide to roll the gain into an EIS which will delay the payment of tax. An EIS also gives income tax relief and falls outside the estate for IHT purposes after two years. There are risks associated with this type of investment which means it will not be suitable for every client.

If your client needs to replace some of the rental income, consideration ought to be given to taking out a discounted gift plan (DGP) or loan plan using the balance left over after the CGT has been paid or rolled over into an EIS.

A DGP is a trust-based scheme that enables the settlor to carve out a right to a regular payment scheme for life. These are suitable for clients who require a pre-determined regular payment throughout their lifetime and who wish to combine this with IHT planning. Generally, there is a choice of absolute or discretionary trusts available.

Loan plans are for clients who want to do IHT planning, but cannot quite give up access to their capital. Using a loan plan allows clients access to their capital at any point and in any amount but the growth will not be included in their estate for IHT purposes.

If they do not need access to their capital, they can either make an outright gift or set up a discretionary gift plan for the benefit of their family.

Using life cover to fund the IHT

Where clients do not want to sell their BTL property, the remaining option is to take out a life policy to cover the IHT liability.

Generally, when clients need life cover to pay their IHT bill, they will use a life cover plan wrapped inside a trust. They will usually use an exemption, i.e. the annual gift exemption of £3,000 per person or the normal expenditure out of income exemption to cover the premiums used to pay the life cover. Rental income counts toward the acceptable income to enable the client to utilise the normal expenditure out of income exemption.

All premiums that are not exempt will either be CLTs, if using a discretionary trust, or PETs if using an absolute trust. This means that seven years' worth of premiums will use up some or all of the client's nil rate band (NRB) on death. In some circumstances, if the premiums are very large, there is a potential for an IHT entry charge to be triggered when using a discretionary trust.

Summary table…

Choices for BTL		**Notes**
Outright gift		
CGT	Disposal giving rise to CGT at 18% or 28% above the AEA of £6,000	No cash realised to pay CGT
IHT	PET for seven years	
Income tax	No income available otherwise gift with reservation	
Gift into discretionary trust		
CGT	Holdover gain	
IHT	CLT for seven years	IHT entry charge if cumulation, plus value of property, is over £325,000
Income tax	No income available for settlor	Trustee rates of tax apply to income
Selling		
CGT	Disposal giving rise to CGT at 18% or 28% above the AEA of £6,000	Roll gain into EIS and invest the rest
IHT	Any scheme or gifting generally takes seven years to drop out of IHT cumulation	
Income tax	Can use DGP or loan plan to replace rental income	No income tax if withdrawals are within 5% cumulation
Using life cover		
CGT	No gain crystalised	
IHT	Premium will be PETs or CLTs unless exemption used	

Income tax	Rental income retained	

Case study

Darren has built up a substantial BTL portfolio which makes up most of his estate apart from some small inheritance tax scheme (ITS) investments, i.e. the shares of AIM-listed and unlisted companies qualifying for IHT business relief. He is getting to an age where he is thinking about IHT planning and asks you for advice as to how to mitigate this tax on death. He is not averse to selling some of his BTL portfolio.

He has stated that he lives off the rental income and is an additional rate taxpayer. Therefore, any gains will be subject to 28% tax.

You suggest that he sells a couple of the properties with the least capital gain which will realise funds he can use to do IHT planning. To mitigate some of the gain, you suggest that he invests in an EIS which will not only roll the gain over but will give him 30% income tax relief based on the amount invested.

Darren is an additional rate taxpayer which means that the income tax savings will be substantial and, in addition, the value of the investment will fall outside his estate after two years. Any future growth on the EIS will not be subject to CGT. However, when he disposes of the investment, the original gain will be resurrected based on the tax rates due at the date he rolled the gain into the EIS. You also inform him that, if he holds the EIS until death, the rolled over gain will be wiped out based on current tax rules.

The balance of the sale of the properties can be invested in an IHT effective scheme, depending on whether Darren needs to replace some of the rental income lost due to the sale. If he takes out a DGP, not only will he secure a regular payment stream until death, if the payments taken do not exceed the 5% cumulation (including charges) he will not have an immediate liability to income tax. In addition, if he is in good health, he may get an immediate discount for IHT purposes.

The balance of his IHT liability can be covered by using a whole of life policy written into a discretionary trust. He has excess income each month and will be able to utilise the normal expenditure out of income exemption to cover the life policy premiums. You remind him that he cannot count the withdrawals from the DGP as part of his income when he calculates his income compared to his expenditure for the exemption.

In summary, although the sale of the property has generated a capital gain this has been rolled over into an EIS. The EIS allows Darren to claim 30% of the payment into the scheme against his income, the gain is deferred and there are no future gains on any increase in the value of his investment. After two years, the value of the EIS will be outside his estate for IHT purposes.

Darren realises that this type of investment is highly risky. However, on weighing up the tax advantages for him, i.e. 30% income tax relief, 40% IHT saving and a deferral of his rolled over gain with no further gains accruing, he is happy to take the risk. The size of the EIS is small compared to his overall investment portfolio.

The balance of the investment is invested into a DGP which gives Darren a regular payment stream which is not taxable at the moment, which replaces his taxable rental income. He also qualified for a discount immediately and, after seven years, the full investment will be outside his estate for IHT purposes.

The life cover taken out covers the remaining liability with the premiums being met out of his normal income.

Conclusion

As you can see, it can be problematic doing IHT planning for clients where their estate consists mainly of BTL property. It may be that a combination of options may be the best route for your clients.

020 7183 3931
www.riskassured.co.uk