

# Bricks and mortar

**CARL ISLAM** and **STEPHANIE CHURCHILL** consider the practical application of the residence nil rate band, including drafting issues and claiming the relief.

The rules on inheritance tax residence nil rate band (RNRB) have now been in force for a few months and we are starting to face some of the practical issues associated with such a complex piece of legislation. A taste of this is given by comments by the likes of James Kessler QC and Charlotte Ford in their book *Drafting Trusts and Will Trusts – A Modern Approach*: ‘FAs 2015 and 2016 have introduced a residence nil-rate band which enormously complicates the drafting of wills...’.

Chris Whitehouse, in *The residence nil rate band – some preliminary comments*, explained: ‘Although the intention is to ensure that the house can be passed on death with the benefit of the additional nil rate band, this is not how the rules work. The extra nil rate band is set off against the chargeable estate and so reduces the total tax bill charged on that estate. But, of course, there may still be tax payable and it may still be necessary therefore to sell the house to pay the bill!’

Most practitioners will now at least be familiar with the inheritance tax residence nil rate band (RNRB) and *Taxation* has featured some earlier articles in this area, namely the two-part ‘Property pinball’ (26 January 2017, page 12 and 2 February 2017, page 10) by John Woolley and Helena Luckhurst and ‘Flexible friends’ (20 April 2017, page 14) by Stephen Haggett.

This article considers the rules in more detail and some of the more problematic practical areas. All statutory references are to IHTA 1984 unless specified otherwise.

## KEY POINTS

- The residence nil rate band is being phased in from April 2017.
- The relief is tapered away if the estate is worth more than £2m.
- The relief from more than one pre-deceased spouse can be transferred.
- Relief may still be available, even if the property is no longer used on death.
- The relief cannot be set against inheritance tax on lifetime gifts.
- A claim for downsizing addition must be made within two years of the end of the month the taxpayer died.



## Value

The new relief is intended to allow individuals to pass on the family home on death and is in addition to the standard inheritance tax nil rate band (NRB). The relief is being phased in and the maximum annual allowances are:

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

The maximum amount and taper threshold are subject to indexation increases by reference to the consumer price index (CPI). The earliest increase will be in 2021-22.

The RNRB is limited by the value of the residence, so it cannot exceed the value of the chargeable estate of the testator (T). Any agricultural or business property relief is deducted before calculation, as are any debts or charges on the residence.

The maximum RNRB is subject to tapered withdrawal if T’s estate exceeds £2m. In effect, this means that the relief is unavailable once the net estate exceeds £2.35m. Therefore these rules affect taxpayers who have estates worth more than the standard nil rate band (£325,000) but less than £2.35m. Consequently, it is important for taxpayers who fall within these wealth brackets to review their existing wills and, if appropriate, put in place steps to improve their overall family position.

## Transfer

For married couples and civil partners, unused RNRB can be transferred if the surviving spouse or civil partner dies after 5 April 2017. The maximum transferable RNRB in 2017-18 is £200,000.

If the RNRB was not used in full when the first of the couple died, the unused percentage can be transferred to the surviving spouse or civil partner’s estate in a similar way to the existing NRB.

## JOANNE

Joanne died on 7 July 2017 and left her 50% share of the family home to her son. Her share was worth £250,000. Her full RNRB will be offset against the value of her 50% share and there is no RNRB available to transfer to her husband. If her 50% share had been worth £75,000, she would have 25% of her RNRB available to transfer to her husband.

The amount of the transferable RNRB is capped at an additional 100% of a surviving spouse's available RNRB. However, more than one pre-deceased spouse's RNRB can be transferred. As with the NRB, it is the unused percentage of the RNRB that is transferred, not the unused amount.

If the first of the couple died before 6 April 2017, their estate would have used none of the RNRB because it was not available. The full RNRB will therefore be available for transfer unless the value of their estate exceeded £2m and the RNRB is tapered away.

For estates below the taper threshold, if the value of the RNRB is below the default allowance, the RNRB is available for transfer to any surviving second spouse or civil partner ('S2' – see s 8E(2)). However, if the value of the residence passing to direct descendants equals or exceeds T's default allowance, the RNRB available is the default allowance, so none of the RNRB is transferable to S2.

This is illustrated by the examples of *Joanne* and *Samuel*.

Without undertaking any further planning, Samuel's RNRB would transfer to his wife, Audrey. However, because her estate will exceed £2.7m, no RNRB will be available.

In this situation, it would be sensible to consider a deed of variation of Samuel's will to leave an interest in the main residence to his children. This would enable them to claim his RNRB.

Further, because failed PETs are not brought into account for the purposes of claiming the RNRB it might be possible for Audrey to make a series of gifts to ensure that her estate is below the £2m threshold on her death.

## SAMUEL

Samuel died on 16 August 2017 with the following estate:

Asset	Value £
Main residence (50%)	1,000,000
Car	50,000
Cash	500,000
Total	1,550,000

In his will, Samuel left all his estate to his wife, Audrey, whose assets after probate consist of the following:

Asset	Value (£)
Main residence (100%)	2,000,000
Cars	100,000
Cash	1,000,000
Total	3,100,000

## JAMES

James died on 28 October 2017. His net estate was valued at £450,000, which included a house worth £150,000. He had lived in the house until he was rehomed in sheltered accommodation in 2015. From that date, the property had been rented out generating an income for him. The house is left to his three grandchildren in his will.

On his death, full RNRB is available against the value of the property.

## Availability

For the purposes of calculating the inheritance tax payable on a death on or after 6 April 2017 (s 8D to s 8M), the RNRB is available if:

- T's estate includes a qualifying residential interest; and
- all or part of that interest is left to one or more lineal descendants (in other words, it is 'closely inherited').

The RNRB must be claimed (s 8L) within two years from the end of the month of T's death or, if later, three months from the date that T's personal representatives start to act.

## Qualifying residential interest

A qualifying residential interest (QRI) is an interest in a dwelling house (including a garden or grounds of any size) that was T's residence at any point during his ownership of it. This includes foreign property.

The requirement is for the property to have been T's residence at *some* point. Thus, and as illustrated by *James*, the fact that the property is no longer used by the individual and is, say, rented out at the date of death does not preclude the relief being available.

## Closely inherited

The availability of the RNRB also depends upon the residence being 'closely inherited'.

Section 8J(2) states: 'B inherits the property if there is a disposition of it (whether effected by will, under the law relating to intestacy or otherwise) to B.'

Inheritance must therefore be on death and can be by way of:

- the will;
- the intestacy rules;
- survivorship;
- the trustees making an RNRB gift post-death under s 144 (which is read back to the time of death, thereby qualifying for the RNRB);
- the trustees conferring an interest in possession on T's surviving spouse or civil partner (S) within two years of T's death, which will be treated for inheritance tax purposes as if the will had conferred an immediate post-death interest on S; and
- a deed of variation (DOV) or disclaimer read-back under s 142(1). But this involves a trap for the unwary.

‘Closely inherited’ is defined as inherited by:

- A lineal descendant, such as a child or grandchild.
- A spouse, civil partner or (non-remarried) widow of a lineal descendant.

The term also includes an adopted child, step-child or foster child. However, a lineal ancestor does not qualify – so T cannot leave the property to his parents and obtain relief.

It does not matter what the beneficiaries do with the asset after they have inherited it. They can keep it or sell it. There is no requirement to retain the asset after its inheritance.

## Lifetime trust assets

Be wary of the many pitfalls when trusts are used to own residential property (either during lifetime or on death) as set out in the ‘Flexible friends’ article.

If a person has a qualifying interest in possession in settled property, this forms part of their estate on death. So, if that settled property includes a residential property – as in *Wilma* – the estate will be eligible for the RNRB should the property be closely inherited. However, the RNRB will *not* apply if the property passes to a succeeding interest in possession.

Clearly, there will be no opportunity to apply the RNRB to residential property held within a lifetime discretionary trust because the asset is not within T’s estate on death.

If the residence is left on trust by way of the will, the availability of the RNRB will depend upon the type of trust. We will consider the differences below.

## Discretionary trusts

If a property is left into a discretionary trust – as in the example of *Jack* – the RNRB will not be available even if all beneficiaries are lineal descendants. This is because the beneficiaries are not treated as the beneficial owners of the property.

Therefore, it is important that lifetime trusts and wills are reviewed to ensure that any potential issues are identified.

To avoid the trust being created, it might be possible to put in place a deed of variation within two years of death. On a practical note, there can be problems if the beneficiaries include future children and grandchildren because it is necessary for all parties to agree to a variation. Many discretionary trusts cater for unborn generations and it might be necessary to apply to the court to vary this type of arrangement.

Another option is for the trustees to make an appointment of the residential property to lineal descendants under the

### WILMA

Wilma dies on 24 December 2017. Her husband died in 2005. He passed his share of the property into a life interest trust for his wife and Wilma has lived in the property since.

Because the property is treated as Wilma’s for the purposes of calculating inheritance tax, the RNRB will be available against the full value of the property in her estate.

### JACK

Jack dies on 18 September 2017. His wife died several years earlier and left all her assets to him. His will leaves the whole of his estate onto discretionary trust for the benefit of his family and includes the family home worth £500,000.

Without undertaking further planning, no RNRB will be available against Jack’s estate.

provisions of s 144 within two years of death. In this case, the appointment is read back to the date of death which should enable the RNRB to be claimed. However, if no action is taken, no RNRB will be available to the estate.

## Immediate post-death interest

Generally, an immediate post-death interest (IPDI) will be effective in providing access to the RNRB because the beneficiary is deemed to own the asset. However, sometimes an IPDI can be set up as a discretionary trust in the first instance. It may therefore be necessary to review its terms to ensure that the RNRB is available.

To use the RNRB it will be necessary to transfer part or all of the residence to the life tenant.

## Restoration

As mentioned above, if the RNRB is not available because, for example, the residence is a discretionary trust asset, as in *Jack’s Family Trust*, the trustees can restore it by making an RNRB gift post-death under s 144 (which is read back to the time of death and so qualifies for the relief). As long as the trust is unwound within two years of death (in other words by the trustees appointing the trust assets to S absolutely) this will be treated for inheritance tax purposes as if the assets had simply been left by T to S outright. Alternatively, the trustees can confer an interest in possession on S within two years of T’s death, which will be treated for inheritance tax purposes as if the will had conferred an IPDI on S.

## Absolute gifts

The relief will be available if T makes an RNRB gift of his residence (up to the value of the RNRB) to a lineal descendant absolutely under the terms of their will. However, the RNRB is not available against lifetime gifts of residential property. But if T has made a lifetime gift of a residential property which is then

### JACK’S FAMILY TRUST

In *Jack* above, the trustees of Jack’s Family Trust take advice and decide to appoint the property to his three sons under s 144 on 31 May 2018.

Because this is within two years of the date of death and the appointment is to lineal descendants, the gift is read back to the date of death and the full RNRB will be available.

## JOHN

John gifts half of his house to his two children, but he continues to live there. He does not pay rent to the children for use of the property. On his death, the value of the half-share of the property that has been given away will be taxed in John's estate under the gift with reservation rules.

However, because the beneficiaries of the property are his children, the RNRB may be available.

taxed in his estate under the gift with reservation rules, and the gift is to a lineal descendant, the RNRB will be available. This is illustrated by the example of *John*.

## Testamentary planning

The RNRB cannot be set against inheritance tax on lifetime gifts (failed PETs). So if a taxpayer gave away a half share in a QRI worth £175,000 to their son during their lifetime (say before moving into a care home) but died three years later, it is not possible to set the RNRB against this. Instead, the transfer will eat into their standard NRB on death.

Remember that the RNRB is in addition to T's main NRB (which is frozen at £325,000 until 5 April 2021) and, if a successful claim is made, the unused amount is transferable to 'S'.

## The downsizing addition

An important but hugely complicated area relates to the downsizing provisions. These rules are an attempt to prevent taxpayers losing the benefit of the RNRB when they downsize due to age or circumstances. To qualify, three conditions must be met:

- the taxpayer disposed of a former home and either downsized to a less valuable home, or ceased to own one, on or after 8 July 2015;
- the former home would have qualified for the RNRB had it been kept until death; and
- at least some of the estate is inherited by the deceased's direct descendants.

The amount of the downsizing allowance available is normally equal to the RNRB that would have been lost because there is no longer a former home in the estate. It will also depend on the value of other assets left to direct descendants. However, it can never exceed the RNRB that would have been otherwise available. See *Patricia*.

A claim for downsizing addition must be made within two years of the end of the month the taxpayer's death. The personal representatives make the claim as part of completing the inheritance tax returns. The adjustment to the RNRB is based on the difference between the value of the residence that was sold previously and the new one.

To rely on the downsizing rules, careful records must be assembled and kept of the proceeds of sale (or of the residence value at the date of a gift) so that the 'lost' RNRB may be ascertained when needed. If the disposal included a gift, it would be advisable to obtain a valuation at the time of transfer.

## PATRICIA

Patricia's husband died several years ago. She continued to live in their house, but it became too big for her and was difficult to maintain. Therefore, she sold the house for £250,000 and moved into a smaller rental property.

On her death, as long as the equivalent amount of assets are left to lineal descendants, her executors can claim the RNRB against her estate.

A further consideration should be made when drafting wills. It may be necessary to include a 'top-up sum' in the will to ensure that sufficient value passes to the lineal descendant to use the full relief available.

It directs that an additional amount be paid to the lineal descendant if insufficient value attaches to the property owned at death, which might be likely when downsizing.

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Clearly this means that additional value (the difference between the current value of the property and the full amount of downsizing relief) is passing to the lineal descendant/s in question and it is important that T is aware that this is necessary if they wish to use the RNRB in full. Because the top-up sum is not a book entry, to ensure and maintain an equal division and distribution of T's estate, express provision will need to be made in the terms of the will to adjust percentage shares of residue.

## Conclusion

The new rules have confused many practitioners and some, no doubt, are doing their best impression of an ostrich. It is therefore no surprise that most clients have no clear understanding of how the rules work. These are hugely – and one might say unnecessarily – complicated and there are many pitfalls that need to be avoided. One certainty is that now is the time for clients to review their wills and for their advisers to ensure clients are aware of the potential pitfalls that might arise if they do not make the necessary changes. ■

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