Bricks, mortar and IHT

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LEE SLEIGHT, NICK VAUGHAN AND TOM MCELLIGOTT EXPLORE UK INHERITANCE TAX IMPLICATIONS FOR OVERSEAS OWNERS OF UK RESIDENTIAL PROPERTY

KEY POINTS

What is the issue?

The wider inheritance tax implications of holding UK residential property.

What does it mean for me?

If this issue has not been identified, it may result in gaps in clients' wealth and succession planning, exposing estates or heirs to potential tax or liquidity issues.

What can I take away?

The ability to guide clients in obtaining advice on their residential property holdings, in order to understand their exposure and put appropriate UK inheritance planning in place.

Lee Sleight TEP *is Head of Business Development (Asia) at Lombard International Assurance, Luxembourg,* ***Nick Vaughan*** *is a Partner and* ***Tom McElligott*** *is a Senior Associate at Withersworldwide, London*

Demand for UK residential real estate has remained consistently high through the years, with overseas clients forming the majority of investors. In particular, Asia-based clients have traditionally had a close affinity to the UK, with London an attractive destination for second homes or investment opportunities.[1]

The appeal of owning prime real estate, combined with potential returns through appreciation and income, ensures that bricks and mortar are an integral and significant asset class within many portfolios. Many clients, even though well advised on the purchase itself, often overlook the longer-term implications of owning this type of asset.

A number of countries in Asia do not yet apply worldwide taxation and many do not levy estate or gift taxes. Not affected in their home country, clients from such jurisdictions could therefore be excused (but not exempt) for not understanding that UK inheritance tax (IHT) applies to UK-*situs* property, regardless of where the owners and heirs are resident.

Many clients may be surprised when they realise that, having acquired the property, they have simultaneously acquired a latent UK IHT liability, which, at 40 per cent on the value of the property, is a substantial amount.

Simply put, the acquisition of a London townhouse valued at GBP10 million would attract a UK IHT bill of around GBP4 million. To compound matters, this also extends to all UK residential property owned indirectly (for example, via an offshore vehicle) due to changes made to the *Inheritance Tax Act 1984* in 2017.[2] Although it is hoped that many new purchasers would be aware of their liability, it is questionable how many existing owners are cognisant of this fact.

With cash purchases set to make up a significant proportion of property acquisitions in 2023,[3] many buyers may

be exposing themselves and their families financially. Although there may be an ambition to reduce the net value of the property (and therefore the taxable basis) via the use of debt, this approach may not always be successful, especially where the general concept is understood but the intricacies are not fully appreciated.

For example, any debt must be appropriately secured against the UK property in question to be deductible for IHT purposes. Debt taken out for any purpose other than the acquisition, maintenance or enhancement of the property will not be deductible, even if properly secured against it. This rules out any deduction in a scenario where a UK property was purchased with cash but mortgaged at a later stage and the borrowed funds were used for anything other than maintenance or enhancements to the property.

It also means that remortgaging does not present an opportunity to increase the amount of debt secured on a property and thereby reduce the IHT exposure further. Any scenario where a mortgage is paid off and replaced risks affecting the IHT deduction and so should be undertaken with care.

Furthermore, to the extent that a debt that would qualify for deduction against the UK property is also secured over non-UK-*situs* assets, any IHT deduction will effectively be undone by the creation of a separate IHT exposure over these non-UK assets given as security.

CONSIDERATIONS

There are various considerations to the use of debt finance in relation to UK property and, with interest rates at levels not seen for a significant period, clients should certainly pause and reflect before taking out significant debt.

More fundamentally, it should also be considered that the way in which a property is held may impact upon the succession and IHT treatment upon death. Property that passes between spouses is entirely free from IHT where their domicile statuses match for UK tax purposes, and so married individuals (or civil partners) should be advised to ensure any UK property interest they hold passes to their spouse on their death.

Where a property is owned by a couple as 'joint tenants', on the death of one owner the surviving owner will automatically receive the deceased co-owner's share of the property. This process, known as survivorship, renders any will irrelevant in relation to the property in question and, for spouses who own a property together, this should ensure the spouse exemption applies on the first death.

On the other hand, the succession of property held as 'tenants-in-common' is not governed by survivorship, so respective shares in a property would not pass by survivorship on the death of a co-owner. It is therefore crucial for co-owners who hold as tenants-in-common to have appropriate wills in place. In the absence of such wills, the succession of a share in a UK property held as tenants-in-common will pass under the UK intestacy rules. These may not ensure the whole interest passes to a surviving spouse where there are also children who could inherit. Without appropriate planning, at least part of the property interest could pass to the children. This would not qualify for the spouse exemption and IHT could be payable.

Even if owners were able to take advantage of the spouse exemption on the first death, when it comes to the death of the survivor, it is likely that at least some IHT would be due at that stage.

With the taxes due in a very short window after death, advanced planning to ensure that there is adequate liquidity to meet the liability is essential. It makes sense to ensure that adequate liquidity is planned for, removing any unwelcome burden for the family and reducing the need for a forced sale of either the property or other family assets at an inopportune moment.

In practice, liabilities can easily be addressed by liquidity planning via highly effective and simple life insurance solutions that can cover international lives assured, on a joint-life last-death basis. Where spouses know that no IHT will be payable on the first death because of the spouse exemption, joint-life last death policies can provide better value coverage to meet the liability, when it actually arises on the second death. With clear annual premiums, such solutions may help to ensure that this becomes just another day-to-day expense associated with property ownership.

Although we do not expect any changes to tax law in the near future, this cannot be guaranteed and there is always a risk that the legislation may change, which may have an effect on a pure risk policy.

CASE STUDY

Background

Mr and Mrs Tan, both 65 years old, are Malaysian nationals and residents. They have built up a significant UK residential property portfolio, valued at GBP10 million, over the past 15 years. This portfolio has created a significant potential IHT liability of around GBP4 million. They have two adult children to whom they will steadily gift the properties.

Solution

Mr and Mrs Tan opt for a pure risk policy subject to English and Welsh law. A joint-life second-death term of 20 years for a death benefit of GBP5 million is selected to allow for an element of growth in property values over the term.

The term selected will provide adequate IHT protection over the period of ownership and cover the period over which the properties will be gifted to their children. A fixed annual level premium gives clients clarity on costs to ensure that IHT liability can be met in GBP, avoiding any need to liquidate property, or other assets, to meet the IHT.

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1 Knight Frank, *The Wealth Report*, 17th edn. (2023), p.63 **2** bit.ly/3PQs3SO **3** bit.ly/48ru8f8