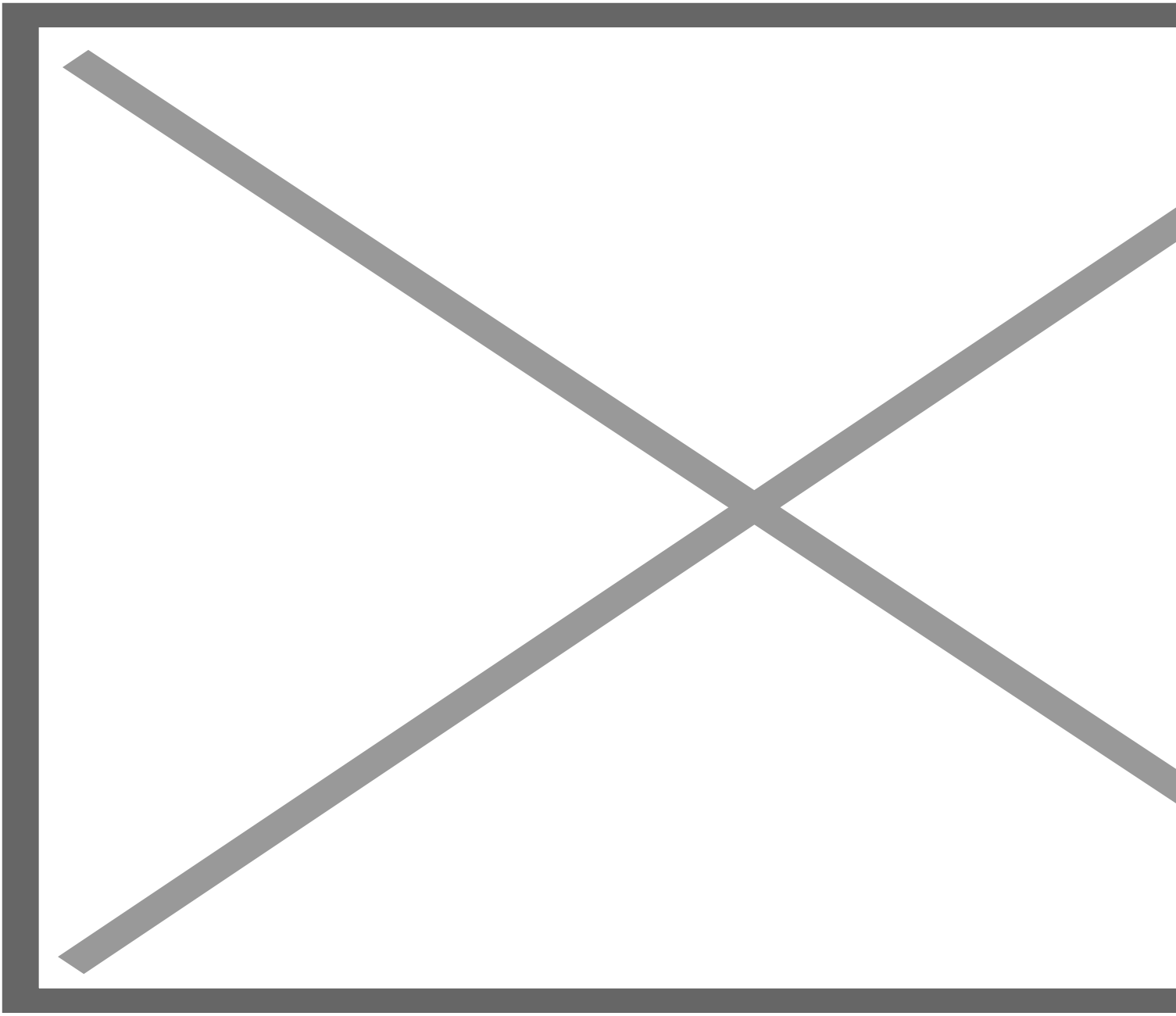
e=mc2

Inheritance tax and trusts



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Malcolm Gunn provides a practical guide to dealing with the new IHT downsizing relief

Key Points

What is the issue?

Where a person sells their home and moves into care, downsizing relief ensures that the appropriate amount of the RNRA can still be claimed by children and grandchildren who receive legacies on the person's death.

What does it mean to me?

Downsizing applies only to homes sold on or after 8 July 2015 and where jointly owned must be worked out separately for each joint owner.

What can I take away?

In many cases where a valuable residence was sold in lifetime, the relief will simply top up any reduced RNRA on death back to its full amount.

If you have looked at Schedule 15, FA 2016, you may have decided already that evening classes in e=mc2 would be preferable to the task of trying to understand the algebra in this Schedule (e.g., E = TT/2). Before you book yourself in to the said classes, I hope this effort at 'downsizing relief made simple' will help.

It will be recalled that the residence nil rate amount (RNRA) takes effect for deaths on or after 6 April 2017. The allowance will start at £100,000 and will rise annually thereafter to give relief of £175,000 by 2020/21. It is available separately to husband and wife and if it is not used on the death of one it can be carried forward for use on the death of the survivor on a similar basis to the transferable nil rate band. As regards the brought forward amount, if the first death was before 6 April 2017 (and no matter how far before it), a full RNRA is brought forward because it could not have been used at the time.

RNRA tapers for estates over £2 million, and so also do the brought forward allowances just mentioned . These estates get an adjusted allowance, but estates not within the taper have what is known as a default allowance.

The new relief

Downsizing relief is for those who have sold a main residence and either they have not replaced it or they have bought another residence of lower value which is retained until death. As we shall see, the rules are carefully and cleverly devised in order to give a mathematically correct result, but in doing so the relief has become impossibly complicated and beyond the understanding of the average client. As tax advisers we soon learn that it is crucial that we make our advice understandable and digestible, and while this relief is therefore welcome it is also unappealing to clients as something they can understand.

In basic terms what the relief does is to work out what percentage of RNRA would have been available if the client had died at the time of selling a more valuable property and downsizing. That percentage of the full RNRA on death can then be claimed to top up the claim in the estate. The top up is limited to the value of other assets which are closely inherited.

The first thing to remember is that the disposal of the residence as part of the downsizing operation must take place on or after 8 July 2015. Any downsizing before that date is outside the scope of the relief. Executors must make a claim for it and can nominate which previous residence is to qualify for the relief, if more than one

residence would qualify. The downsizing rules also take into account the taper rules which apply for RNRA itself, but in this article I will not deal with these partly for the sake of simplicity and partly because the tapering provisions are a complication which will not often apply until the full RNRA is available in 2020/21, even then it may remain relatively uncommon. Most estates will be either over the taper limit, or beneath the £2 million level.

Downsizing to a less valuable residence

Under this heading the following conditions must first be satisfied:

Condition A is that either:

(a) there is a residence in the estate on death which qualifies for RNRA but the full amount is not due because the value of the residence, or the proportion inherited by direct descendants (i.e. closely inherited), is below the maximum RNRA available for the estate; or

(b) there is a residence in the estate on death but none of it is closely inherited and the value of the residence is less than the full RNRA available for the estate.

Condition B is that the value transferred by the chargeable transfer on death is more than the value of the residence then held (because the downsizing relief will be given against other closely inherited assets).

Condition C is that the person previously had a residence which could have qualified for RNRA.

Condition D is that the value of the former residence has a value greater than the chargeable value of the residence in the estate at death.

Condition E is that at least some of the other assets in the estate must be inherited by direct descendants (closely inherited).

Where these conditions are satisfied the downsizing addition is the lost relievable amount but limited to the value of other assets, or proportion of that value, which are closely inherited.
So then we have to work out the lost relievable amount. The calculation involves four steps.

Step 1 is to express the market value of the former residence as a percentage (not greater than 100%) of the RNRA which would have been due on a death at the time of its sale, including any brought forward allowance which might have been available at that time, but uprating that to whatever the actual brought forward allowance on death may be.

Step 2 calculates the percentage of the residence nil rate band at death that is used up by the residence at death.

Step 3 is to subtract the percentage given by Step 2 from that given by Step 1 (but not less than 0%).

Step 4 multiplies the person’s allowance on death by this percentage to determine the lost relievable amount.

For downsizing after 7 July 2015 and before 6 April 2017, the RNRA at that time is treated as £100,000 and the brought-forward allowance to be included is whatever amount of that allowance is available on the death of the survivor.

We can now put all this into a simple example which does not involve brought forward amounts.

Example

Steve owned a residence known as First Gables, which he sold in July 2016 for £800,000. He downsized to Final Gables which cost £400,000. On his death in June 2019 he still has Final Gables worth £400,000 and his remaining assets are valued at £1 million.

He leaves one quarter of his estate to his children and three quarters of his estate to other more distant relatives. HMRC have said that they will regard this as a gift of one quarter of the assets to direct descendants. The children are therefore treated as inheriting a one quarter interest in Final Gables worth £100,000 and other assets worth £250,000.

The RNRA is limited to the value of the residence inherited by lineal descendants, so in this case it is £100,000 and £50,000 goes to waste (because the RNRA for 2019/20 is £150,000). Downsizing relief is due because the conditions above are satisfied, and in particular that under the first subheading under condition A. The lost relievable amount must now be calculated. On the sale of First Gables in 2016, the RNRA is treated at that time as being £100,000. Therefore under step 1, the value of First Gables far exceeded this allowance so we arrive at a percentage of 100%. Under step 2 the percentage of the main residence nil band used up at death is £100,000 out of £150,000, this being 66.66% of the full relief which would otherwise be available. Under step 3 we subtract 66.66% from 100% to arrive at 33.33%. Step 4 therefore allows one third of the allowance of £150,000 on death to be given relief.

We can see from this simple example, that the complex mathematics have produced a correct result in that the downsizing relief has restored the full allowance on the death.

Brought forward allowances

Things get more complicated in the case of married persons or civil partners, where one pre-deceases the other without fully utilising his or her RNRA. In principle, the percentage of the allowance not used on the first death can be transferred to the survivor in the same way that unused nil rate bands can be transferred. So returning to the example and following through the four steps, let’s assume that Steve was married to Julie and they both left Wills on the same terms as set out above, subject to a provision that if one survived the other then the survivor should take the whole estate.

A transitional rule for a disposal of a residence on downsizing which takes place before 6 April 2017 says that the RNRA available at that time is limited to the sum of £100,000 plus any brought forward allowance which is available on the death of the survivor.

Let’s assume therefore that Steve and Julie owned First Gables jointly and they sold it in July 2016. Julie dies in June 2018 and Steve dies in June 2019 leaving one quarter of his estate to his children as in the example above. Steve has an allowance on death of £150,000 plus the full brought forward allowance of £150,000. The allowance which he might have had when First Gables was sold is the limited amount of £100,000 plus the brought forward allowance on death of £150,000, total £250,000 (see transitional rule above). It will be seen that on these figures the percentage figure in step 1 remains at 100%, his one half of the sale proceeds of First Gables being far in excess of £250,000. The fraction at step 2 is 33.33% being £100,000 divided by £300,000. Under step 3 we subtract 33.33% from 100% to arrive at 66.66%. So the downsizing relief is 66.66% of £300,000, which is £200,000. This is the relief to be given in relation to the other assets which are closely inherited and so will always be limited to whatever the value of them is. Once again the relief has restored the full RNRA on Steve’s death.

The calculation becomes slightly more complicated where the residence sold is less valuable so that at the time of the sale of it, it could not have provided the full amount of RNRA available at that time. For example, if First Gables had been sold for only £400,000, then Steve's one half share would be £200,000 at the time of sale. This value would not have used all of Steve's potential RNRA at that time (deemed to be £250,000 as above) and so the figure at step 1 becomes 80%. Under step 3 we now deduct 33.33% from 80% to give 46.67% and so the downsizing relief on death is that percentage of £300,000, to give an amount of £140,010.

Sale of residence without purchase of another

Conditions H–J must be satisfied under this heading:

Condition H is that the value transferred by the chargeable transfer on death must be greater than nil.

Condition I is that the person previously had a residence which could have qualified for the residence nil rate band.

Condition J is that at least some of the other assets in the estate are inherited by direct descendants (closely inherited).

Where these conditions are satisfied the downsizing relief is available but the amount is limited to the value of other assets, or proportion of that value, which are closely inherited. The lost relievable amount is a simpler calculation in these cases. Assume that in the first example of Steve above he sold First Gables and did not buy another house, but moved into a care home. Steve's lost relievable amount under Step 1 gives a figure of 100%. So the claim is for that percentage of the RNRA on death, limited of course to the value of assets which are closely inherited.

Logical but complicated

Downsizing relief gives a logical result once you work through the calculations but how much simpler it would have been not to have any RNRA relief coupled with downsizing relief, but to stick to the original plan which was to have a nil rate band of £500,000, giving total allowances to a married couple of £1m. As it is you can now choose between studying Einstein's e=mc2 and downsizing's E-TT/2!