



Deferred Leases

A major consideration for anyone owning a property portfolio is how to minimise the Inheritance Tax liability for your family. The "Gift with Reservation of Benefit" (GROB) rule makes any gift of the property ineffective for Inheritance Tax if the original owner retains the rental income. If you're reliant on that income, you're stuck. This applies to owners of buy-to-lets, commercial property and rental property portfolios. The use of a Deferred Lease can solve this problem.

A Deferred Lease allows you to reduce any Inheritance Tax payable on your death on your rental properties whilst retaining the rental income from them in your lifetime

As a freeholder, you can set up a long lease, commencing in the future. You can then pass on that lease to a trust for your children so that the value of the gift will be significantly discounted because of the delay until the lease begins. You will retain the rents as the freeholder until the lease commences. The key is to manage the timing so that the freehold expires around the same time as you die.

A CASE HISTORY

Philip, a 65-year old landlord, has a portfolio of rental properties worth £1m and relies on the rental income to live on. He would like to pass the properties to his children free of Inheritance Tax.

The Solution

As the freeholder of the properties he will carve out a 299 year lease, to commence in 21 years' time and give that lease either to his children or more likely to a trust for his children. The consequences are:

1. Philip has passed to the children or trust for the children, property potentially worth £1m, as a lease for 299 years will carry virtually all the value in the properties.
2. As the lease is not to commence for 21 years, the present value of the gift of the long lease is substantially discounted, say by 75%. The gift made by Philip is therefore say £250,000 and is within his Nil Rate Band.
3. Philip retains the "tail end" freehold. Given that the lease is deferred for 21 years the rents will continue to belong to Philip for those 21 years as the freeholder. There is no reservation of benefit for Inheritance Tax purposes as he does not benefit from the asset given away (the leasehold). Philip retains the rents for those 21 years (i.e. until aged 86) by virtue of the retained freehold. There is therefore no infringement of the Gift with Reservation of Benefit rule. This is a completely uncontroversial point.
4. Philip's freehold will still have a substantial value at the point of creating and passing on the lease. However, the value of that freehold will rapidly diminish during the 21 year period.

Notes:

1. The deferral period of 21 years is put forward purely as an example. The deferral period will need to be carefully judged to ensure that it matches or exceeds the life of the landlord but equally it does not extend too much beyond his life. (If there is too much of the freehold left after the landlord's death then the freehold might still have some taxable value). In some cases it should be possible to match the deferral to the date of death or thereabouts.
2. The freehold and leasehold can be merged following death.



Deferred Leases - FAQs

Are there any age restrictions for landlords?

The ideal age is 60 upwards. The younger the landlord, the bigger the discount but we cannot go too young as there would be too many uncertainties in the very long deferral period. We can go up to any age depending on the health and life expectancy.

Which properties can this scheme be used for?

The Deferred Lease strategy is applicable only to freehold and unencumbered (i.e. free of mortgage and any other debt or charge) properties and is suitable for:

- Commercial properties
- Buy-to-let properties
- Portfolios of let property
- Properties or portfolios of up to £1m (single people) or £2m (married couples) though this may be higher or lower according to age
- Holiday or second homes (though in some cases other techniques may be preferable)
- Properties which are personally owned (not property owned through a company) and have been owned for at least 7 years.

Which properties can this scheme NOT be used for?

This strategy is not suitable for the family home, leasehold properties or properties owned for less than 7 years or any property carrying a mortgage or other debt.

Once set up can I cancel?

With difficulty. You should assume that once set up it cannot be revoked or cancelled.

What if I outlive all expectations?

If you outlive the deferral period then the rental income is no longer yours; it now belongs to the children.

Is there a limit on property value?

We recommend a property portfolio of up to £1m for a single person or £2m for married couples. It is all to do with the discount. On a 21 year deferral we may get a 65%-70% discount, so £2m of property could pass under two Nil Rate Bands. Younger or older ages may have an impact on the period of deferral and hence the amount of the discount.

How long does the property have to be owned for?

At least 7 years. This is because a significant interest in land would normally be subject to gift with reservation of benefit rules. However, in the Deferred Lease scheme, the freehold which is retained does not count as a significant interest if it was acquired at least 7 years ago. (s102A Finance Act 1986).

Are there consequences for other taxes?

The creation and gift of the Deferred Lease will be a part disposal for Capital Gains Tax. If this is an issue, then so long as the recipient is a trust for the children rather than the children themselves, holdover of the gain will be available. The gain can be rolled into the trust and deferred until a subsequent sale or the next disposal.

There will be no Stamp Duty Land Tax (SDLT) as there is no sale. (There is no SDLT on gifts.)

Does the deferred lease scheme work?

HMRC accept the effectiveness of the strategy if properly implemented. Full success depends on the client surviving to somewhere near life expectancy. If the taxpayer dies shortly after implementing the arrangement then the planning will in practice be ineffective as there will have been very little value shifted from the freehold to the lease.

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