

## IHT residence nil rate band and FA 2019

### (Lecture P1145 – 23.18 minutes)

The concept of the residence nil rate band was introduced by the previous Chancellor on 8 July 2015. The legislation was set out in F(No2)A 2015 and took effect on 6 April 2017. This IHT relief represents an additional nil rate band which is conditional upon a residential property being passed on death to one or more direct descendants. The residence nil rate band currently has a limit of £150,000, rising to £175,000 in 2020/21. Any unused residence nil rate band can be transferred to a surviving spouse (or civil partner) who meets the relevant requirements. For estates with a net value of more than £2,000,000, there is a tapered withdrawal of the relief which operates at the rate of £1 for every £2 of value over the £2,000,000 threshold.

Following FA 2016, the residence nil rate band is also available where a person downsizes their residence or ceases to own a home on or after 8 July 2015, given that the former home would have qualified for the residence nil rate band had it still been owned. In this situation, assets of an equivalent value, up to the limit of the relevant residence nil rate band, can be passed on death to one or more direct descendants on a tax-free basis.

S66 FA 2019 makes amendments to the residence nil rate band, with the key change clarifying the operation of the downsizing provisions so that they accord with the Government's original intentions (which previously they did not). Unfortunately, the new legislation, which applies to deaths occurring on or after 30 October 2018, is less favourable to taxpayers than the old rules were.

The key change referred to above can be found in S66(3) FA 2019 which amends Step 2 of S8FE(9) IHTA 1984. Step 2 of S8FE(9) IHTA 1984, which was introduced by FA 2016, was initially described as follows:

‘Express QRI as a percentage of the person's allowance on death, where QRI is so much of VT as is attributable to the person's qualifying residential interest, but take that percentage to be 100% if it would otherwise be higher.’

For this purpose:

- QRI, which stands for ‘qualifying residential interest’, means the portion of value transferred under S4 IHTA 1984 which is attributable to the qualifying residence;
- VT, which stands for ‘value transferred’, means the value transferred by the chargeable transfer (the speaker's italics) under S4 IHTA 1984.

The new version of Step 2 reads:

‘For “VT” substitute “the value transferred by the transfer of value (the speaker’s italics) under S4 IHTA 1984”’. As a result, the requirement of Step 2 is:

‘Express QRI as a percentage of the person’s allowance on death, where QRI is so much of the value transferred by the transfer of value under S4 IHTA 1984 as is attributable to the person’s qualifying residential interest, but take that percentage to be 100% if it would otherwise be higher.’

It is important to appreciate the critical IHT distinction between ‘transfers of value’ and ‘chargeable transfers’. A transfer of value is defined by S3 IHTA 1984 as any disposition made by a person as a result of which the value of that person’s estate immediately after the disposition is less than it would be but for the disposition. On the other hand, a chargeable transfer is any transfer of value made by an individual that is not a exempt transfer (as defined) – see S2 IHTA 1984.

Until 29 October 2018, only the value of the qualifying residential interest comprised in the deceased’s estate which is part of the ‘chargeable transfer’ was counted, whereas, in the future, the value of the qualifying residential interest comprised in the deceased’s estate which is both chargeable and exempt has to be considered. In other words, this point is relevant where a residential property passes on death in part to, say, a surviving spouse (i.e.. an exempt transfer) and in part to a direct descendant such as a son or daughter (i.e.. a chargeable transfer).

#### *Case study*

Neil, who is married, downsized from a house worth £400,000 to a bungalow in March 2019. The maximum residence nil rate band for 2018/19 is £125,000.

Neil died in February 2021, leaving the bungalow (which was valued at £105,000) to his widow and daughter equally. He also left shares and other assets worth £480,000 to his son. The maximum residence nil rate band for 2020/21 is £175,000.

Prior to FA 2019, the correct statutory calculation of Neil’s residence nil rate band should have proceeded as follows:

Step 1: The maximum residence nil rate band at the date of the downsizing was £125,000. Neil’s house was worth £400,000 when it was sold. Divide this latter value by the maximum residence nil rate band at the date of the downsizing and express the result as a percentage. However, this can never exceed 100% (which is what we have here).

Step 2: When Neil dies, the bungalow is worth £105,000. The correct figure to be used in Step 2 is one half of this amount, given that a half-share was left to an exempt legatee and so the value transferred by Neil’s chargeable transfer (i.e.. the half-share left to the daughter) was only £52,500. Divide this value by the maximum residence nil rate band available at the date of his death (£175,000) and express this as a percentage, i.e.. 30%.

Step 3: Deduct the percentage found in Step 2 from the percentage found in Step 1, i.e.  $100\% - 30\% = 70\%$ .

Step 4: Multiply the maximum residence nil rate band at the date of Neil's death by the percentage found in Step 3. This produces  $70\% \times £175,000 = £122,500$  – it represents Neil's 'lost' residence nil rate band.

Neil only leaves one half of the bungalow to his daughter. So the residence nil rate band due for that home is:

$$\frac{1}{2} \times 105,000 = £52,500$$

Given that Neil leaves shares and other assets worth £480,000 to his son, the downsizing addition is the lower of:

- (i) his 'lost' residence nil rate band (£122,500); or
  - (ii) the value of shares and other assets bequeathed to a direct descendant (£480,000),
- i.e.. £122,500.

This amount should be added to the residence nil rate band relating to the bungalow (£52,500) to give a total relief of £175,000.

Neil's chargeable estate is:

	£
Bungalow	105,000
Shares and other assets	<u>480,000</u>
	585,000
Less: Spouse exemption	<u>52,500</u>
	<u>£532,500</u>

Given that Neil's aggregate nil rate bands will total  $£325,000 + £175,000 = £500,000$ , the IHT payable on Neil's death estate is:

$$\text{On } 500,000 - 532,500 = 32,500 @ 40\% \quad £13,000$$

#### *Revised calculation*

Following the changes instigated by FA 2019, the revised calculation will be:

Step 1: As before

Step 2: The value transferred by Neil's transfer of value (i.e.. the whole value of the bungalow) is £105,000. Divide this value by the maximum residence nil rate band available at the date of his death (£175,000) and express this as a percentage, 60%.

Step 3: Deduct the percentage found in Step 2 from the percentage found in Step 1, i.e..  $100\% - 60\% = 40\%$ .

Step 4: Multiply the maximum residence nil rate band at the date of Neil's death by the percentage found in Step 3. This produces  $40\% \times £175,000 = £70,000$  – it represents Neil's new 'lost' residence nil rate band.

Neil only leaves one half of the bungalow to his daughter. So the residence nil rate band due for that home is:

$$\frac{1}{2} \times 105,000 = £52,500$$

Given that Neil leaves shares and other assets worth £480,000 to his son, the downsizing addition is the lower of:

- (i) his new 'lost' residence nil rate band (£70,000); or
- (ii) the value of shares and other assets bequeathed to a direct descendant (£480,000), i.e.. £70,000.

This amount should be added to the residence nil rate band relating to the bungalow (£52,500) to give a total relief of £122,500.

Neil's chargeable estate is (as before):

	£
Bungalow	105,000
Shares and other assets	<u>480,000</u>
	585,000
Less: Spouse exemption	<u>52,500</u>
	<u>£532,500</u>

Given that Neil's revised aggregate nil rate bands will total  $£325,000 + £122,500 = £447,500$ , the IHT payable on Neil's death estate will now be:

$$\text{On } 447,500 - 532,500 = 85,000 @ 40\% \quad £34,000$$

It is understood that this is the method of calculation that HMRC used for deaths occurring on or before 29 October 2018. If this is so, then some death estates will have been subject to an IHT overcharge.

*Contributed by Robert Jamieson*