HOW TO TRANSFER A BTL PROPERTY TO AN ADULT CHILD TAX-FREE

By specialist property accountant Stephen Fay FCA

Passing on rental property to children tax-efficiently is one of the most commonly-asked queries that we receive, especially from older landlords. However, capital gains tax applies to such transfers, and this can make such transfers unviable – nevertheless, there is a simple yet effective method to mitigate this issue, via the use of a trust.

THE PROBLEM

I want to pass on a rental property to my adult child – why can't I just do that without paying any tax?

A capital 'disposal' occurs when a rental property is transferred from parent to adult child. This means that capital gains tax (CGT) is payable on transfer, and the usual calculation of the tax due applies, ie sale price (in this case market value) less purchase price, less buying and selling costs. This can often be a substantial amount if there has been significant capital growth on the property.

Example: ***Mr Jones wants to transfer a rental property to his daughter, Jill. Mr Jones is a higher rate taxpayer, and the property is valued at £250,000, and was originally purchased by Mr Jones for £100,000. Mr Jones would therefore face a CGT charge of £38,300 (being £150,000 capital gain less £2,000 capital costs and after the £11,100 CGT annual exemption). To make matters worse, as there are no sale proceeds – since this is a simple transfer of an asset – there are no funds available to pay the tax due.***

THE SOLUTION

CAREFUL USE OF A TRUST

The solution to the above problem is for Mr Jones to use a trust, for the benefit of Jill.

A trust is a private legal arrangement that enables the owner ('settlor') of assets (whether cash, property, shares, etc) to transfer these to another person ('trustee'), for the benefit of a 'beneficiary'. For property investors, most trust funds will contain mortgage-free property that produces a rental income.

Step #1 – establish a trust and transfer the property into the trust

Mr Jones appoints a STEP practitioner to create a trust for him (STEP is the 'Society of Trust and Estate Practitioners – the experts in the creation and use of trusts), and then transfers the property into the trust.

The transfer of the property into the trust is chargeable to inheritance tax (IHT); however, as the property market value is less than the IHT 'nil rate band' (£325,000 at November 2016), no IHT is payable (assuming that Mr Jones' nil rate band hasn't already been used).

Step #2 – make a 'holdover' claim to mitigate CGT

As there is no IHT due on the transfer of the property into the trust, a 'holdover' claim can be made under Section 260 of the Taxation of Chargeable Gains Act 1992 (s260 TCGA). This allows the transfer into trust to occur without a CGT charge arising.

Step #3 – transfer the property to the beneficiary (after 3 months)

After at least 3 months has passed, the beneficiary (Mr Jones' daughter, Jill) could receive absolute title to the property.

The transfer of the property would technically be subject to IHT (known as an 'exit charge'); however, no IHT would be payable because the IHT charge would be based on the initial principal charge rate of 0%, since the initial market value (£250,000) was below the IHT threshold (£325,000).

Because the transfer of the property out of trust was technically charged to IHT (but @ 0%), a second 'holdover' claim can be made under s260 TCGA.

Jill's 'base price' for the property is the same as Mr Jones' was, ie £100,000, and so Jill would herself be taxed on a future disposal of the property using £100,000 as her acquisition price.

However, Jill has become the legal owner of the property, and no IHT or CGT has resulted from the arrangement.

SUMMARY

Using a trust can enable an unencumbered BTL property to be transferred to an adult child without a CGT charge arising. For landlords concerned with passing on assets tax-efficiently, this is a powerful, yet simple and cost-effective, way to achieve that objective. Note that no lender will accept the transfer of a mortgaged property into such a trust – nevertheless, by concentrating repayments into an individual property on a one-by-one basis, there can be a tax-efficient transfer of properties to adult children without the need for tax to be paid on each transfer.