

A Lease for Life and an Unexpected Tax Bill

There is a provision in the Inheritance Tax legislation that is not well known and with which one can become involved unintentionally. It concerns “a lease for life” which essentially is when a person is granted a lease of a property (a house or a flat) for his lifetime. Commonly, the accommodation is rent-free. The intention is to give the person security (the lease) to live in that property at no cost (rent-free) for as long as he lives (lease for life). It is an arrangement that might be made to help a needy relation or an elderly former employee of a family or business.

Probably no one expects the Revenue to be interested in the arrangement yet it is, for Inheritance Tax (“IHT”).

The Inheritance Tax provision

The legislation is Inheritance Act 1984 section 43(3) among the tax legislation’s definitions of “settled property”; The section provides “A lease of property which is a lease for life or lives, or for a period ascertainable only by reference to a death, or which is terminable on, or at a date ascertainable only by reference to, a death, shall be treated as a settlement and the property as settled property, unless the lease was granted for full consideration in money or money’s worth;...”

“Settled “ and “trust” can be regarded as synonymous although “trust” is the more colloquial term.

The Inheritance Tax treatment of a lease for life under trust principles

The Revenue applies the principle of a trust to the lease for life. One needs to understand that principle. Where there is a trust with a beneficiary who is entitled to the income derived from the trust’s capital the trust capital is attributed to the beneficiary and on his death IHT is charged on the trust capital. It seems strange that capital that is actually not owned by the beneficiary is nevertheless attributed to him but that is the case with a trust where the beneficiary has an entitlement. The Revenue adapts this principle to a lease for life. Where there is a person occupying a property under a lease that is good for his lifetime the property will be treated as though it were a trust’s capital and the lessee were the beneficiary; on the lessee’s / beneficiary’s death IHT is charged on the property notwithstanding that the lessee did not own it.

Further, in an ordinary trust the IHT is payable from the trust capital itself and similarly with a lease for life the IHT is payable from the property itself; that will be by whoever actually owns the property. This follows from the Revenue treating the arrangement as a trust as that makes the property owner a quasi-trustee and it is a trustee who to the Revenue is the taxpayer for the trust’s liability.

So the property's owner who benevolently gave a rent-free lease for life to another finds himself with a tax bill when the lessee dies! The only way to understand this outcome is that the Revenue regards such benevolence as no different to creating a formal trust to help another and such a trust has always been charged tax when it ends, calculated on the trust property and collected from the trustee.

It must be said that on the lessee's death the amount of IHT is mitigated by the nil rate band, presently £255,000. The nil rate band is, broadly, the amount that each individual can give away in his lifetime or at his death without paying IHT. The value of the property at the lessee's death and the lessee's own assets are aggregated, one nil rate band deducted, and IHT at 40% charged on the surplus. So IHT will be escaped where at the lessee's death the property and the lessee's own assets are altogether worth less than the nil rate band then. However insofar as the nil rate band is exceeded there will be IHT and the property's owner will be responsible for the tax on account of the property.

Where a rent or premium is paid for the lease for life

All the above has assumed that the lease allows the lessee to occupy rent-free that will be the case in the ordinary familial context and whenever the arrangement is non-commercial.

It makes a difference to the IHT where the lessee pays rent during the lease's duration or the lessee pays a premium at the beginning of the lease.

The legislation has the concept of "full consideration" for the lease in question; that is, what is the market rent or the market premium that could be obtained for this particular property (taking its location, size and condition into account) for a term equal to the lessee's life expectancy? A flat in Knightsbridge let for life to a person with a 10 year life expectancy has a rent or premium that could be obtained for a 10 year lease. The same flat let for life to a person with a 40 year life expectancy has a different rent or premium for a 40 year term. The rent or premium would be different yet again for a remote cottage let for life to a person with a 20 year life expectancy. Agents can advise the figures.

The next step is how much of such "full consideration" the lessee pays, if he pays anything. The rule is that the extent that the lessee underpays the full consideration is the extent that the property's value will be treated as a trust. Here are three examples.

1. The lessee pays nothing, neither rent nor premium: so 100% of the property's value is treated as a trust (as above).
2. The lessee pays 25% of the full consideration: so 75% of the property's value is treated as a trust.
3. The lessee pays 100% of the full consideration: so 0% of the property's value is treated as a trust. The last example shows that the only way for none of the property to be treated as a trust, for IHT not to be involved at the lessee's death, is for the lessee to pay the market rent or the market premium for

the property.

One then follows through the IHT consequences of the lessee paying something but less than the full consideration.

The percentage of the property that will be treated as a trust is calculated at the beginning when the lease starts and is constant until the lease ends with the lessee's death.

On the lessee's death that percentage of the property's value at the lessee's death is what attracts IHT. Using the second example, say when the lessee dies the property is worth £300,000 then £225,000 (75%) is IHT taxable; if worth £500,000 then £375,000 is IHT taxable. The value of the 75% is aggregated with the value of the lessee's own assets, one nil rate band deducted, and the surplus charged at 40% IHT.

Using the second example again, say that when the lease began the property was worth £250,000 so that the 75% percentage treated as a trust had a value of £187,500, so safely below the IHT threshold. But the property came to be worth £500,000 when the lessee died of which the 75% is £375,000. Assume that the lessee's own assets were only £25,000; the aggregated values are £400,000. Say that the nil rate band when the lessee dies is £315,000 (it is increased annually by the rate of inflation whereas property appreciation is usually in excess of inflation). Deducting the nil rate band leaves £85,000 to be taxed at 40%, making a tax bill of £34,000 of which the property owner will be responsible for £31,875.

Incidentally, the heirs of the lessee's own assets will pay £2,125 tax on the £25,000 worth of assets that they receive and perhaps be unhappy that the lease from which they receive no benefit prevents their £25,000 being tax free.

Trying to avoid a lease for life

One conclusion that might be drawn is to avoid the occupant being seen to have a lease *for life* yet to have an equivalent security. The difficulty is the legislation's wording "A lease ...which is for life or lives, or for a period ascertainable only by reference to a death, or which is terminable on, or at a date ascertainable only by reference to, a death, shall be treated as a settlement..." (Inheritance Act 1984 section 43(3)). So it is ineffective for the lease to avoid the words "for life" but to make the lease terminate six months after the lessee's death or able to be terminated at any time after the lessee's death or some other such device. Of course there is no difficulty with a fixed term lease but a fixed term lease that is terminable prematurely on a death will be within the legislation. Incidentally the legislation does not require it to be the lessee's death to which its termination relates; it is simply "a death" so a lease for the life of the lessor or indeed of a third party is within the legislation.

Trying to avoid a lease

Another conclusion might be to prevent the occupant being seen to have a *lease* at all. One might grant him only a licence. There are difficulties here. A licence is simply permission to live in a property, revocable at will, and not giving the occupant exclusive possession; such insecurity with the possibility of sharing may not

be what the occupant wants. Another difficulty is that the Revenue will challenge an overt licence that is understood and treated by the parties to be a lease; on a person's death the Revenue will be suspicious that a mere licensee of the property would have had undisturbed and sole occupation for years until his death.

Conclusion

The IHT treatment of leases for life does not necessarily make them impossible for a property owning client but the client does need to know what they involve so that years later when the lessee dies he does not receive an unexpected IHT bill that makes him regret his largesse. Also the purchaser of a property in which there is an existing lease for life needs to investigate whether any percentage of the property's value is treated as a trust so as to incur an IHT bill on him should he still own the property when the lessee dies.