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The family home allowance

Not everyone's a winner with the recently-introduced residence nil-rate band.

Rising property prices have left more families being elevated to millionaire status and dealing with the inheritance tax (IHT) implications that come with it. The Treasury collected £4.6 billion from IHT in 2015/16, compared to £2.69 billion in 2010/11, to reflect a rising year-on-year trend. And that shows no signs of slowing down any time soon.

In attempt to ease the growing burden on families by making it easier to pass on the family home to direct descendants without incurring a tax charge, former chancellor George Osborne revealed plans to introduce the residence nil-rate band in his Summer Budget 2015. The family home allowance, as it's also known, came into force in April 2017 – but the rules are far from straightforward.

How it works

The family home allowance enables people to pass on one property to family members and save on death duties, in theory at least.

It permits the further reduction of IHT due on passing their interest on death in the family home and works on top of the £325,000 basic nil-rate band.

As of 6 April 2017, when an individual dies their estate will qualify for the family home allowance if the deceased owned a home, or a share of one, that is included in their estate and left to their 'direct descendants'. These exclusively include children, grandchildren, stepchildren, foster children, adopted children and their lineal descendants.

Much like the basic nil-rate band, the family home allowance is transferable between spouses and civil partners. The following thresholds for individuals and couples are being phased in over the next four financial years.

Tax year	Family home allowance	Individual's maximum IHT exemption	Couples' maximum IHT exemption
2017/18	£100,000	£425,000	£850,000
2018/19	£125,000	£450,000	£900,000
2019/20	£150,000	£475,000	£950,000
2020/21	£175,000	£500,000	£1 million

From 2021/22 onwards, the residence nil-rate band will increase in line with the consumer prices index.

Exclusions

Childless couples

Controversially, the family home allowance is not available to couples without children. This will potentially result in childless couples having a combined IHT allowance of £650,000 in 2020/21 compared to the £1 million maximum for those with a direct descendant.

Siblings

According to research from LV= Legal Services, one in 10 individuals over the age of 55 could miss out on the family home allowance because they've named a sibling as their main beneficiary.

The family home allowance

Siblings are not classed as direct descendants and, as such, are excluded from the residence nil-rate band. For example, if a married couple's estate is worth £1.5 million and is left to a sibling, anything above the current combined threshold of £650,000 will be taxed at 40%. That will leave the estate with an unwanted IHT bill of £340,000.

Wealthy estates

Estates worth more than £2 million will be penalised in the form of tapered relief by losing £1 for every £2 above the threshold. This will affect owners and beneficiaries of the largest estates. It could also impact homeowners in London and the South East where house prices are higher than average.

Buy-to-let properties

A property owned by the deceased but never lived in by them is not eligible for the additional threshold, ruling out owners of buy-to-let properties, handing out a potential blow to the direct descendants of landlords.

Tax reliefs

Certain tax breaks, such as the business property relief and agricultural property relief, are also ignored when calculating the value of the deceased's estate.

Trusts and wills

Until recently, discretionary trusts have been commonly used to pass on property to children or grandchildren. Now, families who used these as a way of limiting tax liabilities on their estates risk missing out on the family home allowance.

Discretionary trusts are excluded under the expanded allowance because the assets are technically owned by the trust and controlled by its trustees.

The trust becomes active when the first spouse dies. At this point your beneficiaries can remove the order to establish the trust. However, your beneficiaries are unable to fully disband the trust until the death of your partner. At this point, they need to use a deed of variation within two years to take advantage of the family home allowance.

As ever, it's best to speak to a professional if you think this may affect you or your beneficiaries.

Tax planning options

Downsizing addition

If your children have grown up and flown the nest, you may consider selling your family home to move into a property which better suits your needs. It is possible for anyone who downsizes to count the value of their family home towards the residence nil-rate band. This is known as the downsizing addition.

To qualify for the downsizing addition, the lower value property and other assets in the estate must be inherited by direct descendants. The amount of the downsizing addition will roughly equate to the additional threshold lost through the sale of the former home.

It will also depend on the value of the other assets, such as cash or investments. The downsizing option cannot exceed the maximum threshold the former home would have been entitled to through the residence nil-rate band.

Qualifying for the downsizing addition depends on various criteria and it is always advisable to seek expert advice before considering selling your family home.

Gifts

Previous rules on gifts are unaffected by the family home allowance and remain a viable tax planning option. You can give away gifts worth up to £3,000 in each tax year without them being added to the value of your estate. This is known as the annual exemption.

Any unused exemption rolls over to the next year, so you can potentially give away £6,000 in tax-free gifts if you haven't given anything away in the previous 12 months. Be aware, this is capped at £6,000 over a maximum of two years.

You can also give as many gifts of up to £250 per person as long as you haven't used another exemption on the same person.

If you have an excess of income over your needs, you can gift any amount of this excess as long as it's done for the same amount on a regular basis, usually by establishing a pattern of giving such as a standing order. Care should be taken to exclude any regular amount of cash that is capital and not income, such as money extracted as a life assurance bond extraction.

There are also exemptions for gifts around specific events such as weddings, birthdays and gifts to charities.

Seven-year rule

You will still be charged 40% IHT if you give away gifts worth more than the nil-rate threshold of £325,000 and die within three years.

Thereafter, the following tapered relief is applied to gifts made between three and seven years before your death.

Years between gift and death	Tapered relief
Less than 3	40%
3 to 4	32%
4 to 5	24%
5 to 6	16%
6 to 7	8%
More than 7	Nil

Gifts made more than seven years before your death will not count towards the value of your estate and are tax free.

We can help with your estate planning.