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Tax and your home: five key points

It's likely to be your most important capital asset. But do the tax rules impact what you can do with your home?

Do you pay tax if you sell your home? What happens if you rent part of it out? What about inheritance tax and planning in later life? How do you leave your house to your spouse or pass it to your children? This briefing looks at five key areas, flagging potential pitfalls and giving you confidence when it comes to dealing with HMRC.

1. Keep capital gains tax on your radar

The potential for a capital gains tax (CGT) charge on the family home is something that's often overlooked. The good news is that with care and forethought, you can minimise your risk.

Accessing relief

In most cases, a relief called private residence relief (PRR) means that any gain in value on disposing of your property should be exempt from CGT. But conditions apply.

To benefit from PRR, the property must have been occupied as a dwelling, and it must have been your only or main residence throughout the entire period of ownership. If the property has at some stage been your only or main residence, the operation of what is called final period exemption means that you should qualify for PRR for the last nine months you own the property, regardless of whether you live there or not. Rules are different where you are moving into a care home. Here it's the last 36 months that qualify. Married couples and civil partners can only count one property as their main home at any one time.

PRR applies to a dwelling house and its garden and grounds up to the 'permitted area'. This is half a hectare (slightly more than an acre). A larger area of land can be allowed in some circumstances, if appropriate to the size and character of the property overall, and required for its reasonable enjoyment.

Avoiding pitfalls

In many instances, a claim to PRR is straightforward. But some events have the potential to change the equation, meaning that a claim could be denied or restricted. Though the list is not exclusive, complications can arise when:

- you occupy a property only briefly
- you don't move into the property straight after you buy it
- you regularly buy and then dispose of property you live in
- you have periods of absence (whether in the UK or abroad) from the property
- you keep the house but sell part of the garden separately
- you own more than one property.

If you use part of your home exclusively for business purposes, a proportion of the gain may be taxable when you dispose of the property - though other reliefs, designed for business, may be available. It's exclusivity, though, that is the issue here. Where a room is used not just for business, but also for domestic purposes, this should provide a satisfactory solution. With the current trend for homeworking, this is important to keep in mind.

PRR is not available where a property is acquired with a view to gain. This can be difficult to disprove, and there are instances of HMRC challenging claims to PRR, with sometimes quite severe results. The quality of residence is critical. Occupation is expected to show some degree of permanence, continuity or expectation of continuity. A case that went recently to the tax tribunal failed for these reasons. The taxpayer could not prove that 'she spent time actually occupying the property as a residence, eating, sleeping, relaxing, cooking and washing there.' Although she had spent some time at the property, it was held that the 'nature, quality, length and circumstances' of this didn't amount to residence for PRR.

Letting part of the home as residential accommodation can affect claims to PRR. This does not usually include having a lodger. Where relief is restricted because of residential letting, lettings relief may be available. The rules have changed radically for disposals after 6 April 2020, and relief is now only available where you share occupancy with your tenant throughout the period of the let. This condition applies retrospectively.

2. The home can generate some tax-free income

There is an important scheme to be aware of if you make a spare room in your home available for rent. The rent a room scheme was introduced in 1992 to fill a gap in the housing market. Fast forward to the current housing shortage and boom in online marketing, and it's potentially more of a plus than it's ever been. It can be used by tenants (subject to any conditions in the rental agreement) as well as homeowners.

The scheme allows you to generate income up to £7,500 free of income tax by providing furnished residential accommodation in your only or main residence. That could be by taking in a lodger, or by using the house for letting that amounts to a trade, like a bed and breakfast or guest house. The important proviso is that you live in the property at the same time as your lodger or guest – for at least part of the year. The rules work either to exempt rental income or tax it on a more favourable basis. If gross receipts are £7,500 or less, the income is exempt from tax. In this case, you can't claim any of the expenses you incur in letting. Where receipts are above this level, taxpayers have the choice whether to deduct actual expenses or £7,500 in calculating taxable income.

Note that where used for a bed and breakfast or guest house business assessable as trading income, the house where the business is carried on must be your only or main residence, and the other conditions of the scheme must be met as well.

3. The simple property allowance isn't always simple

Budget 2016 announced a new £1,000 income tax allowance for property income. This was to give simplicity and certainty for small levels of property income such as one-off amounts of income from letting a spare room or parking space on a driveway. The way the relief works depends on whether property income is more than the £1,000 allowance or not. Where it's less than £1,000, full relief is automatically given, so that the income is not charged to tax, unless you elect otherwise. Where it's more than £1,000, what's called partial relief comes into play. This means a choice between deducting actual expenses incurred against income; or electing to use the £1,000 allowance as a deduction - in which case no other expenses are deductible. Use of the election should be reviewed each year. In a loss-making scenario, it may be to your advantage to elect not to receive the relief. The allowance has restrictions. It can't, for example, be used as well as the rent a room scheme, and it's not available if you claim a tax reduction for residential property finance costs.

In short, it isn't always simple to make the property allowance work to your advantage. We can help you assess if it will work for you.

4. Inheritance Tax isn't the problem many people expect

It's probably fair to say that Inheritance Tax (IHT) is one of the biggest bogeymen in the tax system. It's charged on the estate at death, and also on some lifetime gifts (to trusts or if the donor dies within seven years of the gift). The rate of tax on death is broadly 40%, and 20% on lifetime transfers (where chargeable). And it's a tax that worries many people.

In fact, relatively few estates are liable to IHT. As regards the family home, the first point to note is that gifts between UK-domiciled spouses (married couples or registered civil partners) are exempt from IHT, whether during their lifetime or on death. This allows you to pass your home to your spouse or civil partner when you die without paying IHT.

The second is that the current £325,000 IHT threshold - called the nil rate band – can often be increased by an additional nil rate band. This is called the residence nil rate band (RNRB). It applies where an interest in a qualifying residence passes to direct descendants: children, grandchildren, stepchildren, adopted or foster children. The RNRB may also be available if you downsize, or no longer own a property (for example following a move into residential care) and other assets are passed on death to your direct descendants.

The RNRB is £175,000 for deaths occurring on or after 6 April 2020 and is frozen at this rate until 5 April 2028. It can only be used in respect of one residential property, and this must at some time have been a residence of the deceased. If not fully used on the death of the first spouse, the remainder can be used on the death of the survivor. The two nil rate bands together potentially create an IHT threshold of £500,000 for each spouse and, where the estate has passed to the surviving spouse on the first death, the relief is effectively doubled on the estate of the surviving spouse. A tapered withdrawal applies for estates with a net value of more than £2 million.

5. Check: do you need to plan to pass the house to the next generation?

For many, use of the IHT nil rate bands will allow the family home to pass to the next generation without an IHT charge. But unfortunately complications can arise, and as usual with tax, advance planning is likely to produce the best outcome.

It's not uncommon for a surviving spouse to ask what happens if they hand the home on to the next generation - or other relatives - during their lifetime. There can be particular tax risks here, especially where someone gives away their home, or a part of their home, but continues to live in it.

Under the IHT rules, if you make a gift to an individual during your lifetime and then live for at least a further seven years, no IHT is payable on death. In technical jargon, you have made what is known as a potentially exempt transfer, and it's the end of the seven-year period that moves the gift from being only potentially exempt to being actually exempt. If you die within that seven-year period, the position is more complex, but in many cases there may still be no IHT to pay. It's only if the value of the estate on death, plus the value of all potentially exempt transfers made within the last seven years, add up to more than the IHT nil rate band that there's likely to be tax to pay. To get this right, however, there is an all-important condition. For a gift to qualify as a potentially exempt transfer, the donor must give up their rights in the asset: it must be what's called a gift without reservation of benefit. Failing this, the property is treated as part of the estate on death.

Clearly these rules can impact the family home. You will be considered to retain a benefit if you carry on living in the house without paying full rent, for example. There are a number of courses of action that may be open to you in circumstances like these. You may choose to carry on living in the property but pay a full market rent, for instance. Alternatively, it may be possible to give away not the whole property, but a share in it, and then continue to live there, on a shared basis with your recipient. In an arrangement of this kind, it would be important to pay at least your share of relevant property costs - and to be able to prove that you had done so.

The gifts with reservation rules may not apply where someone gives away their home, but later needs to move back in for care purposes. Again, there are specific conditions to meet. There must be an unforeseen change in circumstances and the donor must be unable to maintain themself because of old age or infirmity. The occupation must represent reasonable provision by the recipient for the donor's care and maintenance. And finally, the concession only applies if the recipient is a relative of the donor, or of their spouse or civil partner.

For peace of mind, do please talk to us before making any decisions about property transfers or disposals in later life. It's a particularly complicated area, and quite apart from any tax issues, there may be other areas you want to consider, such as how the family home fits into planning for care home fees, for example.

We are always on hand to help you get the best out of the tax rules on property ownership. Please don't hesitate to get in touch.