INTEGRITY

WEALTH SOLUTIONS

INHERITANCE TAX PLANNING

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The Basics

The number of individuals caught by Inheritance Tax (IHT) is at an all-time high with £5.4bn received by HM Revenue & Customs (HMRC) in 2018/19 alone. The cause of the current crisis is largely due to property price inflation outstripping reliefs and exemptions available to homeowners. The current Nil-Rate Band (NRB) of £325,000 has not increased since 2009. What's more, the current £3,000 annual exemption available to individuals hasn't increased since 1981 - almost 40 years ago!

Do you know how much you’re worth?

Most people don’t know the answer to that question. And even if you make an educated guess, there will probably be things that you forget about.

Each individual has a Nil-Rate Band (NRB) available to them which is the value of assets that can be passed to beneficiaries tax free. The current value of the NRB is £325,000 and this rate is fixed until 5th April 2021. Assets beyond this amount are charged IHT at 40%.

Things to consider

Example estate - Mr Smith

Assets	Values
Your home	£375,000
Any other property e.g. holiday home	£150,000
Your household contents including jewellery	£25,000
Cars, boats, caravans	£16,000
Cash	£28,000
Investments (including stocks and shares)	£34,000
Life assurance (which is paid to your estate)	£45,000
Anything you have inherited	£35,000
Any gifts you've made in the last 7 years (including into a trust)	£0
Total	**£708,000**

And any expenses your estate could have to pay…

Expenses	Values
Outstanding mortgage	£50,000
Funeral expenses	£5,000
Other loans	£0
Any debts (overdraft, credit cards, utility bills etc)	£500
Total	**£55,500**

Here's how the tax bill is calculated

Total assets	- Total expenses	= Value of your estate

Value of your estate	- Nil Rate Band (£325,000)	- Residence Nil Rate Band (£175,000)*	= Value that would attract an IHT charge

For a joint estate, you will have a NRB of £650,000 and RNRB of £350,000*. Anything passed to a surviving spouse or civil partner is exempt (if they are UK domiciled), but you need to consider what happens when they die.

Then figure out 40% of this value, and that gives you the total inheritance tax bill.

*From 6th April 2020. RNRB can only be considered if certain criteria are met, please see page 7.

Here's how our example would work out

£708,000	- £55,500	= Value of the estate £652,500
£652,500	- £500,000	= Value that would attract an IHT charge £152,500
40% of this is the IHT bill		= £61,000

Don’t have more than £325,000 in assets?

If you don’t (and you’ve definitely considered all of your assets plus any gifts that you have made over and above your available allowances*), then you don’t need to worry about losing some of your estate to pay an inheritance tax bill. But have you made sure that your assets are protected now and in the future, and that they will go to who you want when you die?

A trust could still be beneficial and a Will is absolutely essential.

*See page 8 for further information.

Main Exemptions

Marital Status

Transfers between spouses (or civil partners) made both during life and on death are exempt from IHT. In addition to this the surviving spouse can inherit both NRB and RNRB.

Nil Rate Band (NRB)

The NRB is the value of assets that, on death, can be passed to beneficiaries free of inheritance tax. Since 2009 the NRB has been frozen at £325,000 (expected to increase with inflation from April 2021 onwards). For married couples and civil partnerships, any allowance that remains unused on first death can be transferred to the surviving partner, meaning qualifying survivors can pass up to £650,000 to beneficiaries free of IHT.

Main Residence Nil Rate Band (RNRB)

Property price inflation is one of the key reasons IHT is now applicable to more individuals than ever. To help counter this the Government introduced a RNRB in 2017 which promises to provide married couples (and civil partners) an inheritance tax free allowance of £1m when combined with their existing NRB. Whilst a useful addition there are a few caveats to this new allowance that individuals should be aware of:

- The introduction is phased rather than immediate meaning it will take until April 2020 for individuals to benefit from the full RNRB of £175,000 per person (from April 2021 the RNRB is expected to increase with inflation)
- Individuals who downsize (or sell outright) on or after 8 July 2015 retain the RNRB to the full value of the original property assuming assets of an equivalent value will be transferred
- The allowance is tapered away for estates with a value of £2m. The allowance tapers away on a 2:1 basis
- The allowance is only available to individuals who are passing the value of their home to direct descendants therefore individuals with no children cannot benefit from the relief (children includes step, adopted and foster children, as well as their spouses)

Annual Exemption

Individuals may make transfers exempt from IHT up to £3,000 in any one tax year with the ability to carry forward the previous year's allowance for one year if not already utilised (as long as the current year's allowance is fully used).

Small Gifts

Individuals may gift up to £250 exempt from IHT to any number of parties (other than an individual in receipt of the annual exemption referenced above or any larger gift) in any one tax year.

Normal Expenditure

An often overlooked exemption is the normal expenditure exemption. This area of planning can be quite complex but generally if a transfer is part of a donor's normal expenditure, is made out of income and doesn't impact their usual living standard, it will be exempt from IHT. If you can prove, you don't need the income, the 'normal expenditure out of income' exemption can really make a different to your IHT position. Financial guidance should be sought in relation to this exemption.

Wedding Gifts

For those getting married or entering into civil partnerships individuals can gift:

- £5,000 if the donor is parent to either party
- £2,500 if the donor is a grandparent or made from the bride or groom to the prospective spouse
- £1,000 if the donor is any other person

Business Relief (BR)

Introduced in 1976, BR is a tax relief provided by the UK Government as an incentive to increase investment in certain types of trading businesses. BR is available at 50% or 100% on businesses, on an interest in a business or a partnership, on unquoted shares and on land, buildings, plant and machinery when utilised in a qualifying trading business.

Pensions

There is a common misconception that, following the changes made in 2015, assets left in an individual's registered pension will be free from tax when passed to their beneficiaries. Whilst this is true in most cases for IHT, it is important to consider the wider tax implications. The first thing to look at is the type of pension:

Defined Benefit

Spouse's and dependant's benefits will be determined by the scheme – usually an annual pension, which can only be paid to a 'dependant' (and is subject to income tax) and possibly a lump sum, which can be paid to any beneficiary the scheme allows (tax free on death before 75 and taxable on death after 75). The death benefits aren't subject to IHT.

Defined Contribution

Any funds remaining on the member's death can usually be passed on to beneficiaries free from IHT but may suffer income tax in the hands of the beneficiaries depending on the member's (or previous beneficiary's) age at death.

- If an individual dies prior to their 75th birthday the proceeds are passed on free from income tax and IHT to their beneficiaries
- If an individual dies after their 75th birthday the proceeds are passed on free from IHT but beneficiaries will have to pay income tax at their marginal rates on any funds they withdraw i.e. 20%, 40% or 45%

Agricultural Property Relief (APR)

APR is similar to BR, meaning some agricultural property can be passed on free from IHT either during an individual's lifetime or as part of their will. The qualification criteria for APR is quite complex and tax advice should be sought by individuals looking to make use of this relief. APR can provide relief at rates of 50% and 100% depending on the type of agricultural property and when the property was transferred.

Individual Savings Account (ISA)

With exception to some AIM based stocks and shares ISAs, all ISAs are fully chargeable for IHT on death. Whilst AIM can offer a shelter from IHT it is generally considered a volatile market meaning it may be inappropriate for many individuals depending on their attitude to risk.

IHT Planning

1. Spend it

You can't take it with you, so the more you spend, the more you will reduce your estate and the potential inheritance tax bill that will be due on death. We work with you to plan out your expenses, against your income and current assets and can forecast how much is affordable to splash out on luxuries such as holidays etc.

2. Gift it

Potentially Exempt Transfers (PETs)

Most gifts to individuals and certain trusts are subject to PET rules. These types of transfers use up some or all of the donor's nil rate band for the following 7 years. In addition, if the PET (either on its own or when added to other chargeable gifts in the 7 years before the PET was made) exceeds the nil rate band the excess is subject to IHT on the recipient of the gift - this element can receive taper relief if the donor survives for over 3 years meaning the amount of IHT due reduces over time until, after 7 years, there is no charge.

Years between date of gift and death	Reduction
3 - 4	20%
4 - 5	40%
5 - 6	60%
6 - 7	80%
Over 7	100%

Chargeable Lifetime Transfers (CLTs)

These are any transfers that aren't PETs or exempt transfers (see main exemptions). These can attract an immediate inheritance tax charge. The most common CLT is when an individual settles assets into a discretionary trust. Contributions to a discretionary trust that exceed the available NRB (on their own or when added to other CLTs in the previous 7 years) will suffer a 20% CLT charge. Where the settlor dies within seven years of creating the trust, a further 20% IHT may be payable (with taper relief potentially available on survival for over 3 years).

Gifts with Reservation

In addition to watching out for PET/CLT charges, individuals need to be mindful of making a "gift with reservation" when transferring assets. This means gifting an asset whilst retaining a benefit from it. Common examples include gifting:

- Property but continuing to live in it rent free
- Tangible assets (e.g. paintings, cars, antiques) whilst still retaining them
- Money whilst receiving the interest

A gift with reservation is not considered a gift for the purposes of IHT and will therefore be treated as remaining part of the donor's estate.

3. Trusts

Trusts are a long established route to potentially mitigating IHT. By gifting money into a trust, you are giving up access or rights to the funds but can remain in control. Before we look at the most common types of trust it is worth being familiar with the key parties involved in their creation:

Settlor:	The individual gifting the assets info trust
Beneficiaries:	The individuals receiving the income and or capital
Life Tenants:	Beneficiaries entitled to the income generated
Remaindermen:	Beneficiaries entitled to the capital
Trustees:	Individual(s) responsible for administering the trust and carry out the wishes of the settlor

Bare Trusts

These are generally considered the simplest form of trust with beneficiaries receiving an automatic and immediate right to both the capital and interest accrued. They can request that the trust assets be passed to them at the age of 18. The assets are part of the beneficiary's estate for IHT purposes.

Discretionary Trusts

No beneficiary has an absolute right to income or assets from the trust. Typically, the trust will define a class or classes of beneficiary (e.g. "direct descendants") allowing assets to be distributed over multiple generations. Contributions to Discretionary Trusts are Chargeable Lifetime Transfers for IHT purposes. There can also be IHT charges over the life of the trust (periodic and exit charges). The trust assets don't form part of any beneficiary's estate whilst within the trust.

Interest in Possession (IIP) Trusts

An IIP trust will have two types of beneficiary, a Life Tenant who is entitled to the income generated by investment assets and the Remaindermen who are entitled to the assets of the trust on the death of the Life Tenant. Trust assets should be invested to balance the interests of these two parties. With an IPDI (or other trust where there is a 'qualifying IIP') trust assets are considered part of the Life Tenant's estate for IHT purposes and can often lead to an unexpected tax bill. Where there is no 'qualifying IIP' the IHT treatment is the same as described above for a discretionary trust.

Loan Trust

As the name suggests, a settlor does not gift their assets away with a loan trust, which differs to the vast majority of others described. This means there is an element of control as the settlor can recall their loan if they require access to the capital. Whilst this may sound an ideal solution due to the "gift with reservation" rule referenced previously the capital will never actually leave the settlor's estate. Only the growth on trust assets will fall outside of the estate for IHT purposes.

Discounted Gift Trust (DGT)

A DGT offers investors an income (that must be determined at outset) for life and an immediate reduction (the discount) in the value of the settlement for IHT purposes. The balance of the settlement (the investment minus the discount) is considered either a PET or a CLT for IHT purposes depending on the type of trust used, meaning the settlor must survive seven years before the assets will be IHT exempt (some of the gift might be covered by the annual exemption in which case that part is immediately exempt). The size of the discount available will be determined by the level of income drawn and the settlor's life expectancy, with larger reductions available to settlors with a long life expectancy who also draw a high income. Where the income generated remains unspent, it will form part of the estate for IHT purposes.

4. Invest it

Unlike gifts and trusts, which typically take up to seven years before they are fully exempt from IHT, Business Relief (BR) -qualifying investments are IHT exempt after just two years provided that the investments are still held at the time of death. Again, unlike a trust-based plan, with a BR investment you maintain full control of and access to your money at all times. BR was introduced as part of the 1976 Finance Act in order to allow small businesses to be passed on through generations without incurring an Inheritance Tax (IHT) liability. The scope of BR has evolved over the years to become a method of investing for individuals looking to reduce a potentially large IHT liability at the time of their death.

*Business Relief schemes are considered high risk investments. These types of investments can be harder to sell if not readily marketable and the timing of any realisation cannot be predicted. You should not invest in this product unless you are willing to risk losing some or all your capital. Tax rules could change in the future.

5. Protect against it

While the options reviewed so far are designed to reduce the value of the estate for IHT purposes, protection policies are designed to generate funds to pay the IHT bill.

Term Insurance

Term insurance is a pure insurance contract with no investment element. While this is typically cheaper than other insurance options, it does not guarantee a pay out as the term might end before a claim is made. In this instance, the life assured may find it difficult to obtain replacement cover, due to being older and their health status may have changed/deteriorated. If an individual takes out a term insurance policy and writes it under trust, on death during the term of the policy, beneficiaries should receive a tax free lump sum.

Whole of Life Insurance (WoL)

WoL policies overcome some of the issues associated with term assurance as cover continues for the policyholder's lifetime. The trade off is higher premiums that, on certain policies, can be reviewed and increase over time. If an individual takes out a whole of life policy and writes it under trust beneficiaries should receive a tax free lump sum. It is not uncommon for individuals to take out life insurance policies to cover the liability due on their estate. Rather than mitigating the liability the payment off-sets it.

Whilst insurance based solutions can look appealing the reality, particularly for older individuals or those in poor health, can be intrusive medicals, the potential for expensive premiums and no guarantee of cover.

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