Estate Planning

REGISTERED · AUDITORS
THE · MAP · PARTNERSHIP
CHARTERED · CERTIFIED · ACCOUNTANTS

How to save inheritance tax

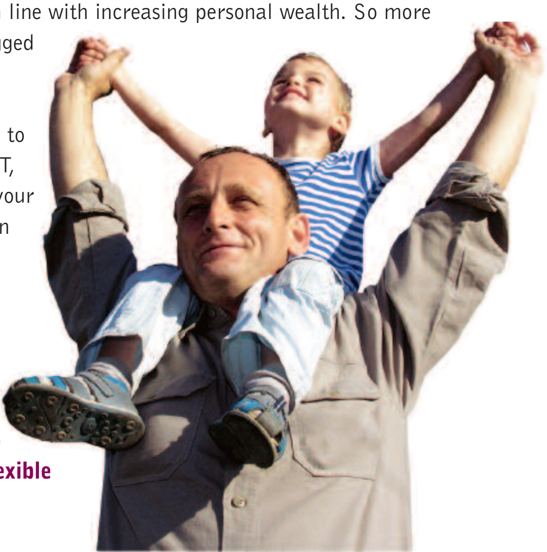
Inheritance tax (IHT) is in the news. It is scarcely possible to open the personal finance pages of a newspaper without some reference to IHT. Indeed, the tax has achieved something of a celebrity status and politicians of all hues and shades have pronounced on its future – some calling for its abolition and others calling for radical reform.

Despite many calls for its elimination, a tax that yielded more than £3 billion in the last financial year and that is relatively simple to administer and collect seems an unlikely candidate for the Chancellor of the Exchequer's axe.

IHT is effectively a tax on people's wealth when they die. Inheritance taxes of some kind have been with us for many years and they have tended to grow even more complicated as time has gone by.

Individual wealth has increased greatly over the last 25 years and IHT now affects an increasing number of families. Rising house prices have been one of the main drivers of this growth in personal wealth. But people also have much more invested wealth than ever before. Successive Chancellors of the Exchequer used the simple expedient of allowing the threshold at which the tax becomes payable to increase in line with inflation, rather than in line with increasing personal wealth. So more families have been dragged into the tax net.

The aim of this guide is to help you understand IHT, how it affects you and your family and what you can do about it in practical terms.



Tax rules change – sometimes suddenly and dramatically. So it is very important to keep your planning flexible and up to date.

Contents

Inheritance tax basics

What is IHT and who pays it?

IHT is basically a tax on everything that you leave when you die. Your home, other property, your savings and investments, even your furniture and pictures all come into the IHT net. That includes property and other assets outside the UK as well.

There is an exception for people who are not 'domiciled' in the UK. Domicile is a complicated concept and essentially refers to the country that people regard as their permanent home – not necessarily where they live. If you have any doubt, you must seek competent professional advice.

How much IHT will I have to pay on my estate?

The main rate is 40%, and that is the rate of tax that is charged on anything you leave that exceeds the nil rate band. The nil rate or threshold for the year ending 5 April 2007 is £285,000.

For example, on death, on an estate worth £500,000, the tax in 2007/08 (see below) could be £80,000. If your estate is valued at £1 million, the tax could be £280,000.

The nil rate band rises each year – although generally not by as much as house prices. The intended levels for the next few years have already been announced. They are as follows:

Nil rate band levels 2007–10

2007/08	£300,000
2008/09	£312,000
2009/10	£325,000

There is also a tax rate of 20% that can apply to certain types of lifetime gifts.

How are transfers taxed on death?

For most people, the only time that IHT is likely to arise is on death, and then only if the estate is worth more than the nil rate band. When someone dies, the value of their estate is calculated and the appropriate amount of tax is levied. Some of the gifts they have made in the seven years before death have to be added back in for this calculation. IHT has to be paid six months after the death, even though many estates take much longer to wind up. Exempt gifts are left out of account. Tax on land and buildings can be paid by installments over ten years.

Again, it is important for the personal representatives of the deceased person to seek professional help at this point.

When are lifetime gifts taxable?

Most gifts that you make during your lifetime are either completely exempt from IHT (see below) or they are potentially exempt. Potentially exempt transfers, or PETS, are free of IHT as long as you survive the following seven years. There is no limit on PETs.

Lifetime transfers into most trusts are not PETs but chargeable lifetime transfers. That means that they are subject to a 20% tax charge to the extent that they exceed the nil rate band.

If you make a gift that has been taxed at 20% and then die in the next seven years, a special relief applies. The 20% tax charge is set against the tax that is payable on the gift on death but does not create a refund.

Exemptions, reliefs and gifts

What are the main IHT exemptions?

Some transfers or gifts are exempt. The main (but not the only) exemptions are:

Spouse and civil partner

Gifts between spouses and registered civil partners are fully exempt regardless of the value that is transferred either during lifetime or on death. This exemption does NOT apply to unmarried partners. In law, there is no such thing as a 'common law husband or wife'.

If the recipient spouse/civil partner is domiciled in another country, the exemption is restricted to a lifetime limit of just £55,000. So if you are married to a person who does not have a UK domicile or simply live with someone, you may have a potentially serious IHT problem.

This spouse/civil partner exemption generally only defers the IHT liability. The gift or transfer will end up in the estate of the recipient and will be liable to tax on their death unless they decide to start planning.

Annual lifetime gifts

Each year you can make total gifts from capital or any source of up to £3,000. This annual exemption of £3,000 can be carried forward for one year only. But then if you do not use it (after using the exemption for the year itself) you cannot carry it forward further.

Example

In August 2006 Ross made a gift of £5,000 to his daughter Briony. He had made no previous gifts. The gift is fully IHT exempt.

	£
2006/07 annual allowance	3,000
2005/06 annual allowance carried forward (part)	2,000
Total gift subject to exemption	£5,000

If you die after making gifts under this exemption, the people administering your estate will need to prove that the gifts were within these rules. So it is a good idea to keep some records.

Normal expenditure out of income

You can make gifts for as much as you like and they will be tax free, so long as they are without any strings attached (ie unconditional) and they are part of your normal, regular expenditure from income. They must also leave you with enough income to keep up your normal standard of living.

Family maintenance

Lifetime gifts for the maintenance of a spouse, registered civil partner, child or dependent relative are generally exempt from tax.

Exemptions, reliefs and gifts... continued

Gifts to charities etc.

Gifts of any amount to UK registered charities are exempt, as are gifts to the major political parties. Gifts to museums, libraries, local authorities and gifts of land to housing associations are also exempt.

Gifts on the occasion of a marriage

Marriage gifts and gifts on the occasion of a civil partnership may be exempt up to certain limits.

Basically parents can give up to £5,000, grandparents can give £2,500 and others can give up to £1,000.

Small gifts

Small gifts of up to £250 are exempt, but they must not be part of a larger gift to the same person. There is no limit to the number of small gifts you can make.

> **Example**
>
> Roma gave £150 to each of her eight grandchildren at Christmas. These presents are IHT exempt as small gifts, as long as she makes no other gifts in the tax year that take the total amount to a grandchild above the £250 limit.

The main IHT reliefs

There are several IHT reliefs. The most important are for certain business assets and agricultural assets.

Business property relief is available for transfers (on death or during lifetime) of certain categories of business and of business assets, if they qualify as 'relevant business property' and the transferor has owned them for a minimum period.

Relief at a rate of 100% is available for:

- The business of a sole trader or an interest in a partnership.
- Shares in an unlisted trading company that are not listed on a recognised stock exchange, including shares that are traded on the Alternative Investment Market (AIM).

There are several conditions for the relief to apply. You must have owned the asset for at least two years before the transfer. The relief does not apply to investment businesses or those that largely consist of dealing in securities and shares or property.

Agricultural relief is only given on the agricultural value of farm land and farm buildings. So the development potential of land or the high residential value of a farmhouse would not benefit from the relief – just the underlying agricultural value.

The relief is generally 100%

where the person making the transfer has owned and farmed the land for at least two years or the person can obtain vacant possession within 24 months. It is also available for tenanted farmland where the lease was started after 31 August 1995.

What are gifts with reservation?

A special rule prevents you obtaining any IHT advantage by giving away assets and continuing to benefit from them.

For example, if you give away your house to your children but continue to live in it, HMRC would ignore the transfer for IHT purposes. Such transfers are called 'gifts with reservation.' To be effective, any property transferred must be enjoyed to the entire exclusion, or virtually to the entire exclusion, of the person who made the gift.

The use of trusts

What are trusts?

Trusts are widely used in IHT planning. A trust is essentially a way of giving where the person making the gift (known as the settlor) places assets with a third party (the trustees) to hold for the benefit of the beneficiaries. The trust deed defines how the trustees should act and what the beneficiaries are entitled to and various other details.

There are several different kinds of trust. Some give the trustees very little discretion – at least where the beneficiaries are adults and are not incapacitated. Some allow the trustees considerable amounts of discretion over the destination of the trust's capital and income and these are therefore known as 'discretionary trusts'. The person making the gift can be a trustee and retain a measure of control.

Why are trusts used in IHT planning?

The essence of IHT planning lies in reducing the wealth on which the tax will be levied. Most people are understandably reluctant to make significant outright gifts, especially if the potential recipients are relatively immature. Trusts can help overcome many objections to making outright gifts.

A gift to a trust counts as a gift for IHT purposes. But the trust acts as a half-way house between giving something away and holding onto it. It allows you to make a gift, but nobody is in a position to use or benefit from that gift without the consent of the trustees. The person who is making the gift can also be one of the trustees in order to retain a measure of control.

You can use your trust to pass wealth down through the generations in a controlled and tax efficient manner.

What can the use of a trust achieve?

A suitably drafted trust can:

- Provide for those who are 'incapable' of dealing with financial issues, such as minor children.

- Protect family wealth from beneficiaries who might take an irresponsible approach to it.

- Make lifetime gifts to family members rather than wait until death.

- Give away property without losing total control over it.

- Save IHT and possibly some other tax as well.

What has the government done about trusts?

The Finance Act passed in 2006 tightens up the IHT treatment of trusts. The changes do not stop the use of trusts for IHT planning, but it has become even more important to take care to avoid unnecessary tax charges.

There are now two main types of trusts that individuals use for IHT planning. These are:

- **Tax privileged trusts** – these are mainly available for very particular situations, for example where the trust is

The use of trusts... continued

created on the death of a parent for the benefit of their minor child or, in lifetime or on death, for a disabled beneficiary. Another tax privileged trust is a bare trust.

A bare trust is an absolute trust for the benefit of a person. The trustees have no ability to change a beneficiary's interest. Provided a beneficiary is legally capable, they can demand the trust property from the trustees.

This can defeat the control that the person making the initial gift may want the trustees to have. The advantage of bare trusts is that lifetime gifts made into them are potentially exempt transfers.

- **More flexible trusts** – under other trusts, lifetime transfers may be taxed and there may also be some tax on the trust assets every ten years and then when assets leave the trust.

Key planning strategies

What are the key IHT planning strategies?

There are many different IHT planning strategies. The following is a brief outline of some of them.

The first step in any IHT planning strategy is for married couples or civil partners to make sure that they have tax-efficient wills. Many married couples or civil partners leave the survivor all their assets. Only after the first of them has died do they leave any of their wealth to their children or, possibly, other family members.

For example, if Fred died first and Mary his widow received the whole of the estate, a nil rate band will have been wasted. It could have passed down to the next generation tax free.

The cost of wasting the nil rate band, in terms of hard cash, is currently, in 2006/7, £114,000 – ie £285,000 @ 40%.

The easiest way to retain the benefit of the nil rate band is to ensure that each spouse's or civil partner's will sets up a trust for the value of the nil rate band, with the balance of the estate passing to the survivor. This ensures that there is no IHT liability when the first spouse or civil partner dies and it allows time for more planning.

It is also a sound idea to build a retirement fund so that if you are contemplating making a series of gifts to save IHT, you can do so with confidence that you will have enough income to live on. All these strategies involve investments whose value can go down as well as up. They also have costs that mean you should regard them as arrangements for the longer term.

Strategy 1
Start a programme of lifetime gifts

The main way to reduce the potential IHT on your estate is to make lifetime gifts. That sounds fine for people who have so much wealth that they can afford to give a great deal of it away during their lifetimes. But you might feel you want to retain some control and flexibility over your assets and you would also like to have some continuing income from them as well.

Fortunately, there are several arrangements that go a long way towards providing these advantages. They are suitable for both single donors and couples, although you should regard them as longer term investments.

- **Discounted gift trusts** allow you to make an IHT effective gift into a trust while still retaining what is in effect an income stream from it for yourself.

For example, you invest, say, £400,000 in the trust and retain a right to £20,000 a year for the rest of your life or until the fund runs out. For tax purposes, the value of the gift would be significantly less than the amount you actually invested in the trust, because you kept your right to the income. The size of this discount would depend on your age, sex and state of health.

- **Loan trusts** are worth considering if you are a rather more cautious person who wants to retain access to your capital at all times. In broad terms, you make a loan to trustees – interest free and repayable on demand. The trustees invest this in a life assurance bond and the investment growth is held for your beneficiaries – perhaps your children or grandchildren. The loan is repaid to you as and when you need it and the balance outstanding at any time remains subject to IHT.

The tax advantages of loan trusts accrue gradually. The gift does not directly reduce your estate, but the growth in the fund takes place outside your taxable estate. This process is sometimes called 'estate freezing'.

- **Back to back arrangements** involve you buying an annuity (which converts capital into income) and then using some (or all) of the annuity payments to fund a whole of life assurance policy held in trust for your named beneficiaries. The IHT advantages are immediate – there is no need to wait seven years. The annuity takes the cash out of your estate straight away and can provide a lifetime income, and the life assurance policy provides tax-free benefits on death.

Strategy 2 Make use of tax relieved investments

You can buy assets that qualify for business or agricultural relief without becoming closely involved in managing a business or farm.

In particular, you can invest in a portfolio of AIM shares carefully selected to include qualifying trading companies. AIM and other unquoted companies are likely to be riskier investments than quoted companies and it is important not to let the tax benefits override normal investment considerations.

You should remember that there is no guarantee the new investment will equal or outperform that of the original and the value of an investment can go down as well as up and you may not get back the full amount invested.

Strategy 3 Use life assurance policies to fund the tax

Using a life assurance policy to fund the expected IHT bill is not really an avoidance strategy, because the policy proceeds will be used to pay the tax and will not be available to succeeding generations. Nevertheless, this is a valuable approach (and perhaps the only practical method) for those people who are asset rich but cash poor.

If you possess a reasonably substantial property or other illiquid wealth and relatively few readily realisable investments, this could be the approach for you. The younger you are when the policy is taken out the better – premiums will be lower. You should not start life assurance policies that you will not be able to maintain. For couples, such a policy should be structured so that the proceeds will be paid out after both spouses or civil partners have died. This is the time when the major tax liability will arise.

It is essential that the policy should be placed in trust – otherwise the policy proceeds will form part of the taxable estate of the surviving spouse or civil partner and will suffer a tax charge.

The policy premiums are usually treated as exempt transfers, falling within your annual exemptions or perhaps qualifying as part of your normal expenditure from income.

Conclusion

Inheritance tax planning involves making important and personal decisions about your future and your family wealth. Circumstances change and so does tax law and the financial environment. Planning can sometimes be complicated, but it is very worthwhile because you can save substantial amounts of tax.

It is exceptionally important to obtain competent qualified advice and to keep the advice and arrangements under regular review. Contact us to review your IHT planning or any other aspect of your financial position.

3rd Floor North The Forum
74-80 Camden Street London NW1 0EG
Tel 020 7388 4141 Fax 020 7388 1236
e-mail: map@themappartnership.co.uk

PARTNERS: P .R. MEHTA V. NADARAJAH-PILLAI