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TOP 6 EASY WINS FOR INHERITANCE TAX PLANNING

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INTRODUCTION

When many people think about estate planning for the first time, it is not uncommon for them to get caught up in the more complex, adventurous solutions.

In the process they have often forgotten about the numerous simple, cost-effective reliefs and exemptions that exist courtesy of HM treasury, as well as some of the other ‘easy wins’ of the estate planning world.

I am still amazed by the number of people seeking my advice on complex, expensive estate planning tools, when they have failed to make use of even the most basic exemptions.

This guide is designed to act as a checklist for some of the more readily available and accessible methods of reducing your inheritance tax liability.

I encourage you to refer to this guide on a regular basis, as many of these savings can be applied year after year.

While these methods are unlikely to deal with anything but the smallest inheritance tax problems in their entirety, they do provide a valuable foundation upon which further estate planning methods can be used. If you take no other action having read this guide, by applying these methods the potential tax savings can run into the tens, if not hundreds of thousands, of pounds.

I will round this guide out with an annual estate-planning checklist to make sure that you are making the most of these simplest of tax savings.

THE CRITERIA FOR A METHOD TO BE INCLUDED IN THIS GUIDE ARE:

1. It is simple to apply and will not necessarily require any specialist advice (although it may be prudent to take it all the same).
2. It has existed for some time and shows no signs of being changed by upcoming legislation.
3. It incurs no additional costs over and above the amount to be gifted (unless a trust is used to receive the gifts – more on this later).
4. It delivers a meaningful inheritance tax saving, given the time and effort required for its application.

THE ANNUAL EXEMPTION

WIN #1

Quite possibly the easiest inheritance tax exemption to grasp is the annual exemption. The rate of the annual exemption is currently set at £3,000, as it has been for many years.

Put simply, this exemption allows you to save £1,200 in inheritance tax each and every year.

The annual exemption allows each individual to gift £3,000 to any other person or trust of their choosing. Once the gift has been made, it is treated as exempt, meaning that it falls outside of the inheritance tax estate immediately.

Given that the annual exemption is a personal allowance, **those in a married couple will have two allowances to make use of, giving a grand total of £6,000 per year.** Expressed another way, that's **an annual inheritance tax saving of £2,400!**

As a final bonus, if you have not been making use of the annual exemption in the past, you are able to carry this forward for one year. So, for example, if you did not make use of the annual exemption last year, you have two allowances to make use of this year. **That's a total of £6,000 for a single person or £12,000 for a married couple to get you started on your estate planning journey.** You can only carry forward the allowance from one previous year.

While these amounts might seem small in the context of a £2m or £3m estate, it is the compound effect of the annual exemption over several years that makes it so interesting.

> "IT IS THE COMPOUND EFFECT OF THE ANNUAL EXEMPTION OVER SEVERAL YEARS THAT MAKES IT SO INTERESTING."

As a simple example, let's take Susan and James, who are both 65 and wish to start making some simple provision to reduce their inheritance tax liability. They decide to make use of the annual exemption in year one (and carry forward last year's allowance) and then make regular use of it each year.

If they each live until the age of 85 they will have made a total of £126,000 in annual exemption gifts in their lifetime (20 years at 2 x £3,000 plus carry-over £6,000), equating to an **inheritance tax saving of £50,400.** Not bad as a starting point!

Things start to get even more interesting when you consider the impact that compounding of investment growth has on your estate value. Most people with significant assets tend to invest those assets to make them grow, whether via property, shares or bonds. **But any growth that takes place within your own estate increases your total level of assets and thus increases your inheritance liability too.**

By growing assets **outside of your estate** you stand to make even more significant savings.

Picking up from our previous example, let's revisit Susan and James, who are both 65 and wish to start making some simple provision to reduce their inheritance tax liability. They decide to make use of the annual exemption in year one (and carry forward last year's allowance) and then make regular use of it each year. **They make the annual exemption gifts into a trust for the benefit of their children.**

This time, the funds are invested within a trust and grow at a relatively modest rate of 4% per annum after fees and charges.

If they each live until the age of 85 they will have made a total of £126,000 in annual exemption gifts in their lifetime. When we factor in the 4% growth on these funds, they will now be worth approximately £196,500, which gives an effective **inheritance tax saving of £78,600.**

THE £250 'SMALL GIFTS' EXEMPTION

WIN #2

While arguably having less impact than the £3,000 annual exemption, the £250 small gift exemption can still make a significant dent in your inheritance tax liability if used effectively.

This exemption allows you to give £250 to as many people as you like and these gifts will be exempt from inheritance tax immediately.

The only caveats are that this exemption cannot be used in conjunction with any other exemption and it does not apply as part of a larger gift. For example, you can't give someone a £250 small gift in addition to the £3,000 annual exemption, nor can the first £250 of a larger gift be treated as exempt (the gift must be less than £250 to qualify).

In practice, these rules limit the potential impact of the small gifts exemption, but this does not mean that it should be overlooked.

If Susan and James have four grandchildren and they both give each grandchild £250 every year between the ages of 65 and 85, that's a further £40,000 removed from their estate, **saving £16,000 in inheritance tax.**

> "THE £250 SMALL GIFT EXEMPTION CAN STILL MAKE A SIGNIFICANT DENT IN YOUR INHERITANCE TAX LIABILITY IF USED EFFECTIVELY."

GIFTS OUT OF REGULAR INCOME

WIN #3

Possibly the most valuable of all the inheritance tax exemptions, and often the least understood, is the gifts out of regular income exemption.

Put simply, this allows gifts to be made to an individual or trust, with no upper limit, so long as the following conditions can be satisfied:

- The gift must be made out of regular, natural income (more on this in a moment).
- There must be some element of regularity to the gifts.
- The gift must not reduce your own standard of living to below that before the gifts commenced.

While not quite so simple to claim or demonstrate, the gifts out of regular income exemption does have the potential to generate a very significant reduction in your inheritance tax liabilities.

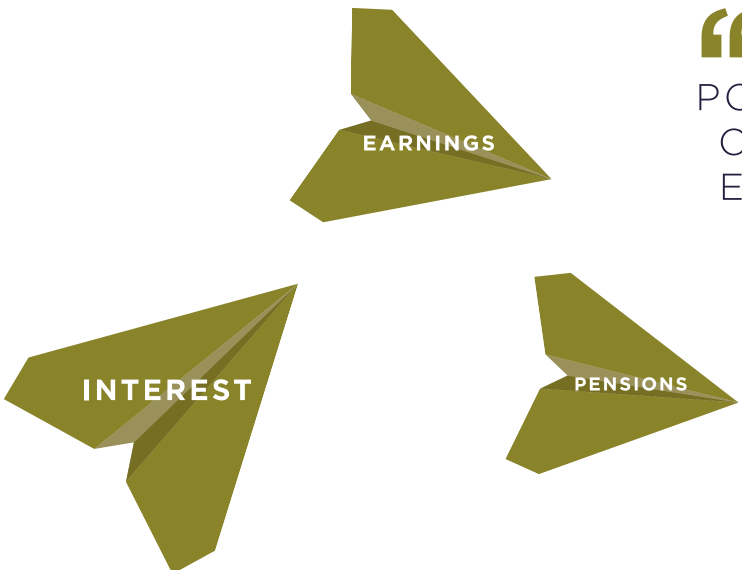
SO WHAT ARE THE CATCHES?

Well, first of all, **the gift must be made out of your regular, natural income.** In simple terms, this means that the gift must be able to be funded by your income generated in that tax year. **The gift cannot be made from capital.** While different people will argue different definitions of 'income', you will be unlikely to antagonise HMRC if you stick to using **earnings, pensions, interest** and **dividends.**

The second requirement is that there is **some element of regularity to the gifts.** While this is a slightly grey area, you will generally be able to satisfy this requirement if gifts are made at least annually. The amount given in each year can vary substantially, so long as the other conditions are met, and there is no limit on how many years these gifts can be made for.

The final condition is often the most difficult to evidence and also tends to cause the most confusion. In order to satisfy this condition for gifts to be exempt under the regular income rule, **you need to be able to show that in making the gifts you have not reduced your own standard of living.** Now clearly this is a significantly grey area and there is some room for artistic licence, but as with anything tax related, it is better to comply with both the letter and the spirit of the rules. So long as you can demonstrate that you are not making significant sacrifices to your own standard of living in order to fund the gift, you should be OK.

The workings of the gifts out of regular income rules are best illustrated by the following three examples...



"POSSIBLY THE MOST VALUABLE OF ALL THE INHERITANCE TAX EXEMPTIONS, AND OFTEN THE LEAST UNDERSTOOD, IS THE GIFTS OUT OF REGULAR INCOME EXEMPTION"

EXAMPLE 1: NO INCOME AVAILABLE TO MAKE GIFTS

Jim has an annual income of £40,000 after tax, which is made up of his state pension, work pensions and a small amount of bank interest. He also has a balance of £420,000 in a deposit account, which he uses to supplement his expenditure when required.

His average yearly expenditure is £45,000, causing him to take a withdrawal of at least £5,000 each year from his savings. He might take a larger withdrawal from his savings if he wants to purchase a new car or take a nice holiday.

Jim is unable to make any gifts under the regular income exemption as his regular expenditure exceeds his income. It is not possible to 'replace' income with capital in the context of this exemption.

EXAMPLE 2: INCOME AVAILABLE TO MAKE GIFTS

Sunita has an annual income of £40,000 after tax, which also comes from a combination of her state pension, work pensions and interest.

For the past three years her annual expenditure has averaged £35,000, including provision for two foreign holidays a year.

Sunita is able to make gifts that would fall under the regular income exemption of up to £5,000 per year, so long as there is some element of regularity to the gifts. In practice, she would need to make a gift at least annually or more regularly to satisfy this requirement.

EXAMPLE 3: SIGNIFICANT GIFTS POSSIBLE

Harjot has an annual income of £90,000 after tax, which comes from a state pension, savings interest and dividends. For the past three years her annual expenditure has averaged £60,000, including provision for expenses related to a holiday home and two foreign holidays a year.

Harjot is able to make gifts that would fall under the regular income exemption of up to £30,000 per year, so long as there is some element of regularity to the gifts. In practice, she would need to make a gift at least annually or more regularly to satisfy this requirement.

The inheritance tax saving available here would be £12,000 per year. Given that these gifts are treated as exempt when they are made, there is no seven-year rule and these gifts fall outside of the inheritance tax net immediately.

Many people are concerned about their ability to claim or evidence the gifts out of regular income exemption, especially where they are intending to gift substantial sums.

A fact that is often overlooked **is that it falls on the executors of your will to accurately report any gifts and exemptions that you wish to claim as part of the returns required to obtain probate.** As such, despite many people's best intentions, significant allowances and exemptions often go unclaimed because of the inability of the executors of the will (often the children) to demonstrate eligibility. This fact is not really surprising. Many people would struggle to detail their own income and expenditure for past years, let alone someone else's!

As a result, **my overriding advice to anyone considering making use of the gifts out of regular income exemption is to make simple records as you go along.** This does not need to be an onerous task in the slightest and your executors and loved ones will thank you for it.

You will find a simple summary that you can use to keep records for the purposes of this exemption in the **inheritance tax Form 403** that you can download from the HMRC website. Again, you can use this form directly, or keep records in another format or spreadsheet, but if you do use a different format, remember that your executors will eventually have to enter these details into Form 403 anyway, so it is a good idea just to use this form from the start.

I would suggest that you complete this form, or something similar, each year in which you wish to make gifts out of regular income. It need take no longer than ten minutes, but could save your executors days of searching through historical records once you have gone.

It may also be a good idea to retain evidence of income and expenditure as far as possible and have this easily filed and accessible for your executors.

WIN #4

GIFTS ON ACCOUNT OF MARRIAGE

While this may not be an exemption that can be used on a day- to-day basis, it is again simple, easy to claim and potentially valuable if used wisely.

In essence, you are able to make gifts to people who are getting married or becoming civil partners that will be exempt from inheritance tax. The amount of gift that will be exempt depends on the person's relationship to you:

IF YOUR OWN CHILDREN | IF YOUR GRANDCHILDREN | FOR ANYBODY ELSE

Again, as a married couple these gifts count double, so you could give £10,000 (2 x £5,000) to your child on marriage.

The only caveat with this marriage exemption is that the gift must be made shortly before (although no official definition exists of what 'shortly' means) or on the date of marriage. Once the rings are exchanged, it's too late.

GIFTS TO CHARITIES OR POLITICAL PARTIES

WIN #5

For those of us who are feeling particularly philanthropic, or who wish to support a certain political cause, the good news is the inheritance tax system is hugely in favour of doing just that.

I could be awfully cynical about the political exemption at this stage, but I shall resist the temptation!

You are able to make unlimited gifts to registered charities, either during your lifetime or on death, and these will be completely exempt from inheritance tax immediately. No seven-year rule to worry about here.

If you are feeling particularly generous, one sure-fire way to eliminate inheritance tax altogether is to give your entire estate to charity or your favoured political party.

For those of us who would like something a bit less extreme, you can consider gifting a part of your estate to charity or a political party to reduce the potential inheritance tax liability.

For example, if a married couple have an estate of £700,000 and wish to eliminate their inheritance tax liability, they could consider making a gift of £50,000 to a charity of their choosing. Assuming they have made no other gifts, the remaining **£650,000** would fall within their nil rate band and would be **free from inheritance tax.**

“YOU CAN CONSIDER GIFTING A PART OF YOUR ESTATE TO CHARITY OR A POLITICAL PARTY TO REDUCE THE POTENTIAL INHERITANCE TAX LIABILITY.”

GO ON A SPENDING SPREE!

WIN #6

This is my most beloved, and the most often overlooked, estate planning tool. If you are in a position to be paying inheritance tax, chances are that you are reasonably well off.

While I am not encouraging frivolous spending for the sake of it, I know of many people who have large pots of assets yet seem afraid to spend them.

I will take a wild guess and say that you most likely worked hard and saved for your future on the basis that you would spend the fruits of your labour at some point down the road.

Perhaps this is that point? Money is for enjoying, you can't take it with you and you only live once. While gifting money to others is fantastic, so is treating yourself.

The best part of this is that **any money you spend, on anything at all, is immediately outside of your estate and will be exempt from inheritance tax.**

Just imagine that – you can have a 40% inheritance tax exemption on that dream holiday, a new car or those home improvements you have been thinking of for years.

THE ANNUAL CHECKLIST

So there we have it, a nice range of simple, easy and effective tools to deal with your inheritance tax headaches. The checklist below can be used on an annual basis to make sure that you are making the most of these oh-so-simple tax-saving tools. If used correctly, these reliefs and exemptions can be worth tens, or even hundreds of thousands, of pounds.

Each year check to see if you have done the following:

- [ ] Made use of the £3,000 annual exemption. If this is your first year, you can carry this back from last year as well. Married couples can have twice the allowance.
- [ ] Made additional gifts of £250 each to as many (different) deserving people as you can think of.
- [ ] Made the most of any available gifts out of regular income.
- [ ] Been generous with those who are getting married, especially children and grandchildren.
- [ ] Considered if you wish to make gifts to charities or political parties.
- [ ] Considered if you could be spending more on enjoying your own lifestyle. I'm serious about this one – there is a 40% inheritance tax relief on anything that you spend!

With these simple and effective estate planning tools now deployed, you can embark on some of the more advanced estate planning solutions, starting with the humble will.

FREE INHERITANCE TAX PLANNING SEMINARS

Buckingham Gate Chartered Financial Planners hold regular Inheritance Tax Planning seminars in Central London.
The seminars are **FREE** to attend, but places are limited.

If you would like to reserve places please email us at **events@buckinghamgate.co.uk** or call us on **020 3478 2160**

THE SEMINARS WILL COVER:

- How to update your will to save thousands in inheritance tax.
- Ways to reduce the inheritance tax liability on your estate.
- How to protect your assets for your loved ones.

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> “BUCKINGHAM GATE PROVIDED EXPERT INFORMATION AND RECOMMENDATIONS ON HOW TO BEST MANAGE MY ESTATE WITH TRUST SETUP, WILL & EFFECTIVE PLANNING FOR IHT. VERY IMPRESSED WITH THEIR KNOWLEDGE AND THE SIMPLE ENGLISH USED TO EXPLAIN HOW TO EFFECTIVELY PUT PLANS IN PLACE TO GIVE ME PEACE OF MIND.”

This case study has been taken from the book Efficient Estate Planning, written by estate planning expert Matthew Smith. You can purchase a Kindle edition or paperback copy from Amazon.

Inheritance tax used to be the preserve of only the wealthiest in society, but with rising property and asset prices more ordinary people have been pulled into its grasp.

In Efficient Estate Planning, Matthew Smith will guide you through easy strategies to reduce your inheritance tax bill immediately, thereby maximising the value and impact of your legacy and simplifying the process for your family of dealing with your estate. The book is suitable for inheritance tax beginners and experts alike.

A BRILLIANT BOOK - SHORT AND SIMPLE TO UNDERSTAND. ANYONE CONSIDERING DOING SOMETHING ABOUT THEIR ESTATE PLANNING MUST PURCHASE THIS. AN EXCELLENT OVERVIEW OF THE OFTEN COMPLICATED AREA OF TRUSTS USING CURRENT TAX EXEMPTIONS & ALLOWANCES.

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