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A GUIDE TO INHERITANCE TAX PLANNING

By **Faith Glasgow**

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THE IMPORTANCE OF A WILL - Write it out now! Without a will the death of one partner may create serious financial problems for the survivor.

LOOK AFTER YOURSELF - Don't give it all away. Ensure you hold on to sufficient capital to provide you with the income you may need in years to come.

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"INHERITANCE TAX IS NOT SOMETHING ORDINARY FOLK NEED TO WORRY ABOUT."...THINK AGAIN!

Inheritance tax, charged on the assets you leave when you die and certain gifts made during lifetime, has long been thought of as a tax on the estates of the well-heeled few – not something ordinary folk need to worry about. After all, it only affects people with more than a certain level of wealth (known as the nil rate band (NRB) because assets below that value are taxed at 0%).

Currently the NRB is set at £325,000, and it will stay at that level until April 2021. If your estate is worth more than that, the excess is taxed at 40%, or 36% if 10% of the net estate is left to a registered charity. So on an estate worth £375,000, for instance, there would be £20,000 to pay (40% of the £50,000 over the NRB).

Our increasing affluence over recent decades has meant more and more people build up enough to be potentially affected. Most significantly, IHT has touched growing numbers of homeowners, as house price rises over the past 15 years or so (even accounting for the housing market correction since 2008) have far outstripped increases in the NRB.

More recently, the Conservative government has also announced plans to take the inheritance tax steam out of rising house prices. From April 2017, an additional 'family home allowance' for homeowners will be phased in, applicable specifically to their main residence; it will start at £100,000 per individual in 2017, rising by £25,000 each tax year to reach £175,000 by 2020. However, the allowance will only be available to those passing the family home on to children, grandchildren or other lineal descendant (as opposed to siblings or nieces and nephews, for instance).

In effect that means that by 2020, individuals will be able to leave up to £500,000, including their home, to the next generation free of inheritance tax. A couple could pass on a house worth up to £1m without any IHT liability (though with a £1m home as part of the estate, any additional assets would then be liable to tax). The allowance will be progressively withdrawn for estates worth more than £2 million.

Older people who want to downsize to a smaller, cheaper property but will end up with a lot of cash in the bank will be given an 'inheritance tax credit' entitling them to the new higher threshold, so long as the estate is passed to direct descendants.

However, while the new rules will help families with more expensive homes reduce their IHT bill (most obviously in London and the south east, where property prices are highest), or even avoid it altogether, many people will not benefit. Those without children will not qualify for the family home allowance, and less benefit will be available those who have less valuable homes (or who rent a property) but own substantial other assets – cash, investments or buy to let property, for example. And of course the changes will not affect anyone who dies before April 2017. So the bottom line is that there's still a key role for estate planning strategies for many people.

It's important to remember that it's never a problem for the person who has passed away – it's the family or other beneficiaries (the people who stand to inherit) who'll lose out if their inheritance is slashed by tax. But most people would like to know that when they shuffle off this mortal coil, their wealth will pass in full to their nearest and dearest, rather than being siphoned off to line the coffers of HM Revenue & Customs. So what can be done to keep your assets beyond the long reach of the taxman? This brief guide outlines eight useful tactics to help keep IHT to a minimum.

WILL WRITING

- According to the Law Society, **a third of British people** die 'intestate' – without a will.
- **Half of those over 45** have not made a will.
- Without a will the death of one partner may create **serious financial problems** for the survivor.
- If you don't leave a will **the rules of intestacy** will decide who gets what.

Clearly will-writing is easy to put off, perhaps because it reminds us that we're not getting any younger and that none of us will live forever. However, there are several reasons why making a will is an important thing to do.

First, it enables you to make the decisions about how your wealth is distributed. If you don't leave a will, the rules of intestacy will decide who gets what. That may mean it doesn't go to your partner, or to the people or charities you'd like to have it.

Thus, under the rules of intestacy covering deaths since 1 October 2014, if you have children or other descendants, your spouse or civil partner will receive any personal belongings and the first £250,000 of the estate, plus half of any remaining balance, with the rest held in trust until the children are 18 and then divided equally between them. If there are no children or other descendants, the whole estate passes to your spouse, and if there is no surviving spouse, it is divided equally between the children.

Parents, brothers, sisters, nieces and nephews may inherit under the rules of intestacy in some cases, but it will depend on whether there are closer surviving relatives or a spouse still in the picture, and on the value of the estate.

Importantly, if you're not married or in a civil partnership, your partner cannot inherit under these rules. Without a will, therefore, the death of one partner may create serious financial problems for the survivor.

Wills can also be used to manage inheritance tax liability. One of the most common ways is through the use of a discretionary will trust. This enables a chunk of your assets (up to the nil rate band) to be earmarked for your children, for example, rather than going straight to the surviving spouse – so it won't count as part of the estate.

Why use a trust? Because the assets are wrapped in a trust, rather than a straight gift to the children, the trustee still has control over them and can arrange for the spouse to receive income from it if needed (for example, if they have to pay for nursing care). There's more about trusts on page 6.

Another option for married couples is to arrange to hold their home as tenants in common (rather than as joint tenants), which means each owns a defined share of the property. Each partner can then stipulate in their will that on their death, their share (up to the nil rate band) should pass to the children, but with a 'lifetime interest' that allows the surviving partner to continue living there during their lifetime.

The biggest attraction of this arrangement is that it can help avoid you having to sell your home to fund long-term care: neither partner owns the whole home in the first place, so it may be disregarded when the local authority makes its calculations.

GIFTS & ALLOWANCES

The first thing to recognise, when you're thinking about your wealth and what will happen to it in years to come, is that even if your needs are quite modest now, you may need to find much larger sums to pay for additional care as you get older. So the priority must be to ensure you hold on to sufficient capital to provide you with the income you may need in years to come, rather than to minimise the risk of inheritance tax for your family.

It makes a lot of sense to take advice from a financial adviser who'll be able to assess how your finances are positioned and whether it's appropriate to try and reduce your wealth at this stage in order to sidestep the risk of IHT.

As we'll see shortly, simply giving away assets doesn't necessarily solve your potential IHT problems. But you can make use of the various so-called 'gifting exemptions' available. These are the financial gifts you're allowed to make every year, and unlike other gifts, they are completely free of any IHT liability.

ANNUAL GIFTING ALLOWANCE

You can give away up to £3,000 each tax year without any tax liability. If you didn't use the previous year's allowance you can carry it forward – so a married couple could give away as much as £12,000 in their first year of gifting.

SMALL GIFT ALLOWANCE

Additionally, you can make as many gifts as you want of up to £250 – though not to the same people who received the annual £3,000 gift.

GIFTS OUT OF NORMAL INCOME

This is a useful exemption if you have more regular income than you actually need in retirement. Provided your normal lifestyle isn't affected, you can make unlimited gifts out of regular income. But you can't give up your annual world cruise to accommodate the gifts you want to make!

OTHER EXEMPT GIFTS

You can also make exempt gifts to people getting married or civilly partnered, though this isn't such a handy regular tax planning tool. They include up to £5,000 from each parent of the couple, £2,500 from each grandparent or more remote relative, and from one partner to the other, and £1,000 from anyone else.

GIFTS TO CHARITY

Gifts of any size to charities or community amateur sports clubs, whether you make them during your lifetime or in your will, are exempt from IHT.

It's really important to keep a formal record of any exempt gift, just in case the taxman needs to see it. That means writing to each recipient to say that you are making an outright gift to them – and then keeping a record of your communication.

GIVING MORE MONEY AWAY

Once you've used your exempt allowances, you may still have spare cash you would like to offload. That will depend not just on how wealthy you are, but also on your health, your lifestyle, and how much capacity you have to boost your income if you need to in the future.

If you are able and want to give more assets away, there is nothing to stop you doing so, to whomever you want. However, be warned – such gifts, known as potentially exempt transfers or PETs, will be considered by the taxman as though they remain part of your estate to the extent that they fall within your nil rate band if you die within seven years of giving them away. Gifts in excess of the nil rate band will create a liability for the recipient if you die within seven years (though the rate of tax does taper over the seven year period). But if you survive seven years, those gifts are completely outside your estate.

If you're sufficiently well-off and start relatively young, it's possible to use your NRB to give away several tranches of PETs. If you gift up to £325,000 worth of wealth, then – provided you live that long – it will fall out of your estate after seven years and you can 're-use' your NRB to make another such gift.

The danger, of course, is that you may give away large sums and then be wrongfooted by events – a disabling medical condition requiring the adaptation of your home, say – and find you did need that extra capital after all.

One option, rather than giving cash to grown-up children to reduce IHT, is to gift a share of the family home (up to the NRB) to them on the death of the first spouse. The surviving partner continues to live there, but pays the children a market rent for use of their part of the property.

Not only will that gift be outside the estate in seven years' time, but in the meantime the parent is also making regular payments of rent to the children – effectively transferring income to them. (Remember this is considered taxable income in the hands of the children). And in the meantime, a cushion of cash remains in the parent's name to meet any changes of circumstance.

USING TRUSTS

Trusts are a formal arrangement, whereby you (the donor) transfer legal ownership of an asset to a kind of legal guardian (the trustees), to manage and distribute in due course to the people you want eventually to have it (the beneficiaries).

They have been used for centuries, for two reasons – to resolve family issues over money, and to reduce tax. Either way, they may be set up while you're alive, or be written into your will to take effect on your death.

Thus, if you want to reduce your IHT liability but don't want to give your wealth away outright – perhaps because your children are not particularly responsible, or you are worried about their marriage or business prospects, or your partner may need access to an income from the assets in due course – you can put those assets into a trust, where the trustees will manage them according to the terms of the trust.

There are many types of trust, but these are some of the most important as far as inheritance tax mitigation is concerned.

1 DISCRETIONARY TRUST:

Under this widely used arrangement you can gift assets worth up to the nil rate band into a trust for your beneficiaries without any immediate tax charge. Those assets will not count as part of your estate if you live another seven years (at which point you can start again with a 'new' NRB).

Importantly, though, although you have given your assets away, you can retain some control over their management and distribution through the trustees. Additionally, any subsequent income or capital gains produced by the assets in the trust are outside your estate from the start.

2. DISCRETIONARY WILL TRUST:

A similar arrangement written into your will – known as a discretionary will trust - works slightly differently. You stipulate in your will that on your death, up to the NRB of assets will be put into a trust in the children's names, which means those assets are outside the estate as far as the surviving spouse is concerned. This set-up can be useful, in that although the money in trust sidesteps the survivor's estate, the trustees may be able to make loans from the trust back to him or her if money is needed, say for long-term care expenses. It amounts to a kind of halfway house between retaining ownership of all your assets and making an outright gift.

3. SPOUSAL BYPASS TRUST:

In some cases where the first spouse to die has untouched pension pots that the survivor will not need to draw on for income, it can also make sense to keep the assets out of the survivor's estate (where they would otherwise go automatically), by placing those pension investments in a special 'spousal bypass trust' earmarked for the children.

INSURANCE PRODUCTS

Life insurance companies have designed various innovative investment products to be held in trust wrappers, with the focus on removing assets from your estate while at the same time providing some income stream.

DISCOUNTED GIFT TRUSTS

These enable investors who don't need all their capital to gift a lump sum into a trust and then receive a regular 'income' from it. They are particularly interesting because at the same time, part of the lump sum (the 'discount', earmarked to pay the income stream over the coming years) is not treated as a gift for IHT purposes, and so reduces the size of your estate. The size of the discount increases, the more you withdraw and/or the greater your life expectancy.

FLEXIBLE REVERSIONARY TRUSTS

If you're in reasonable health, these are another alternative. They don't offer an immediate reduction in your estate, unlike the previous product, but they do remove investment growth from the outset and pay a regular income if required; and you can make gifts to beneficiaries during your lifetime.

INVESTING TO REDUCE YOUR LIABILITIES

If you have substantially more than the nil rate band, you may be tempted to consider using one of the various schemes or products available that invest in assets qualifying for what's known as business property relief (BPR) – you may benefit from up to 100% relief from IHT after 2 years of ownership.

All sorts of investments may qualify for BPR, including shares in unquoted and AIM companies, partnership interests, agricultural land and forestry, and Enterprise Investment Schemes (EISs). But for wealthy older people looking to preserve their capital and reduce their potential inheritance tax burden, the best options are usually a packaged portfolio of shares in companies listed on the Alternative Investment Market (AIM), or possibly a BPR scheme.

■ AIM Portfolio Schemes

Several inheritance tax-oriented schemes are available that invest in AIM shares but are very specific in the type of company they choose. For instance, a number of AIM companies started as family businesses and still have a large family interest, so tend to be quite conservatively managed. Others are actually quite large, well-established firms, but choose to remain on the AIM market rather than moving up to the main market. Investors in AIM portfolio schemes stand to benefit not just from the inheritance tax advantages but also from capital growth over time – but they do have to be comfortable with share prices fluctuating in the shorter term.

■ BPR Schemes

These are special inheritance tax mitigation schemes with the same tax treatment as AIM portfolio services, but with less volatility. They keep the risk down by focusing on shares in slow but steady businesses such as farming, forestry, housebuilding and commercial storage.

■ EISs

These schemes invest in a portfolio of very small companies. They are inherently risky, so they're able to offer investors substantial tax breaks, including income tax relief at 30% and capital gains deferral at up to 28%, as well as IHT exemption after two years. Most EISs would not be suitable for older investors because of the risks involved, but one or two providers have focused on capital preservation above all and are used by some advisers for certain investors seeking to reduce their IHT liability.

LIFE ASSURANCE

In some circumstances it may be easier – or even cheaper – simply to make provision to meet the cost of inheritance tax, rather than trying to avoid it. One big plus is that insurance policies can pay out swiftly, enabling the IHT bill to be settled without delay. (There can be problems for the executors of an estate when the assets needed to pay HMRC cannot be accessed because the estate is still in probate.)

The easiest way is through a life assurance policy; the premiums could be paid by you (if you feel generous) or by the beneficiaries, as they will be the ones to feel the benefit.

Whole of life policies will pay out an agreed sum, calculated to cover the likely tax hit, on your death. They are written in trust so that they themselves remain outside your estate.

'Gift inter vivos' insurance: if you make a PET to a friend or family member but there is concern that you may not survive the next seven years to ensure full tax exemption, it's possible to insure against any potential IHT hit by taking out a single-premium decreasing life policy.

The sum payable falls over the seven-year term, mirroring the tapering inheritance tax liability, and if you die the policy pays out what's due. If you live beyond seven years the policy expires (and the assets leave your estate).

PASSING ON YOUR PENSION

Estate planning options changed significantly from April 2015, with the introduction of major reforms to the pension system – including new rules opening up the potential to leave your pension to your loved ones when you die.

The old pension regime was not designed to enable people to pass on their pensions easily. Historically, most people have bought an annuity with their pension pot when they reached retirement, and when they (and in some cases their spouse) died, it effectively 'died' too. Those who hadn't touched their pots and died before 75 could pass them on tax free; but if they were already drawing an income from it, or were over 75, any remaining pension fund was punitively taxed at 55% when they died.

The new regime is refreshingly uncomplicated in comparison. One cornerstone of the pension shake- up is the fact that there is no longer any obligation to buy an annuity (though it will still be an option), and another is that people are much freer to take cash from their pension fund as they need to. In line with these new freedoms, pension inheritance is also treated much more generously, though the age of 75 is still a watershed.

- If you're under 75 when you die – whether or not you have dipped into your pension – then any remaining fund will pass to your nominated heirs completely tax-free.
- If you're over 75 when you die, your nominated heirs can inherit it as a continuing pension, in which case they will pay income tax on any withdrawals, at their highest (marginal) rate. Alternatively, it can be paid out as a cash lump sum. These lump sums will also now be taxed at your beneficiaries marginal rate after April 2016.

The changes open up many options for clever estate planning ideas, but a couple of basic points are worth highlighting:

NOMINATE YOUR BENEFICIARIES:
Under the old system you could only nominate dependents or family members to receive what was left of your pension if you were leaving an income (lump sum benefits could be paid to anyone), but since April you can leave unused pension funds to anyone at all. But you do need to ensure you let the trustees of the pension scheme know whom it should go to, otherwise it could be paid into your estate which could be disadvantageous from an Inheritance Tax perspective.

PRESERVE YOUR PENSION:
Given the all-round tax-efficiency of pension funds under the new regime, it makes sense to keep your pension for use as a last resort, and make use of other income sources and investments such as ISA's or other taxable investments first, if you have that option.

ISA INHERITABILITY

The rules have also changed for tax-efficient individual savings accounts (ISAs). Since April 2015, anyone with an ISA is able to leave it to their spouse or civil partner completely tax free.

Previously, when an ISA investor died, the ISA wrapper passed away with them, so that the cash, funds or other investments held in it became liable to income and capital gains tax, and this is technically still true. Now however, the surviving spouse can inherit the tax advantage as what is know as an APS (Additional Permitted Subscription) ISA. This means that the surviving spouse can pay in an additional one-off lump sum into their ISA accounts, which is equivalent to the ISA balances of their deceased partner.

The Treasury estimates that 150,000 married ISA investors die every year, with the loss of their tax advantages. In many cases they had built up ISAs worth hundreds of thousands of pounds over the years, so the retention of that tax shelter is a valuable benefit for the survivor.

However, ISAs cannot be passed on to anyone else tax-free; on the death of the second spouse the tax shelter is lost and the assets become part of the wider estate, potentially subject to IHT.

If you have inherited your partner's ISA, therefore, it's sensible to use the income (and capital if necessary) to supplement other income sources, before you deplete any remaining pension pot.

INCOME IN RETIREMENT
A SHIFT IN THINKING

By **Matthew Smith**, Managing Director, Buckingham Gate Chartered Financial Planners

MATTHEW SMITH *is the Managing Director of Buckingham Gate Chartered Financial Planners. In addition to being a Chartered Financial Planner himself, he is a fellow of the PFS and has a Masters in Financial Planning & Business Management from Manchester Metropolitan University. Prior to founding Buckingham Gate, Matthew has held positions at Wesleyan and Lloyds bank.*

With the new pension freedoms legislation now firmly part of the retirement planning landscape in the UK, the true implications of these changes are now starting to be truly understood.

What is clear in our day-to-day work with clients', is that the pension investment landscape (that is, the investment funds that we hold within our pensions) has not quite caught up with the reality of this brave new world.

For a start, we come across clients who are invested in so called 'lifestyle' funds on an almost daily basis. These investment strategies gradually pull people out of 'risk assets' such as equities and property and move them into 'safer assets' such as cash and bonds as they approach retirement.

The problem with this strategy is that it is entirely founded on the basis that most people purchased an annuity at the end of their working life. As such, the funds would be de-risked as the day of retirement approached. The intention being that there would be less risk of the fund falling sharply in value shortly before annuity purchase, when there would be insufficient time to make back any losses.

While this strategy was sound in a world where a good majority of people bought an annuity with their retirement savings, since the introduction of pension freedoms, this appears to be far less common. The figures vary but annuity sales have almost certainly had a significant fall, with one major provider reporting a 75% drop since the pension freedoms announcement. This leads us to the conclusion that many more people are choosing to draw an income from their fund, otherwise known as Flexi-access drawdown.

If someone is invested in a lifestyle fund, but then decides to take an income from the fund over the coming years, rather than purchase an annuity, the investments could have been pulled out of 'growth assets' just when growth is needed the most.

If the Flexi-access drawdown option is chosen, a shift of investment thinking is required as the pension funds accumulated will remain invested, possibly for the next 20, 30 or even 40 years. As such, we would suggest that anyone thinking of taking an income from their pension fund directly, rather than purchase an annuity, seriously consider how appropriate the investments held within their pensions are. It could well be that the perfect investment strategy in the 'old' pension world, leads to the perfect storm in the new one.

We also come across many people who review and manage their other investments on an almost daily basis, but who have not reviewed their pension investments for 20 years or more. The days of the pension being a 'set and forget' investment could now be truly behind us and we would encourage people to consider pension investments as active, just like any other.

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