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ESSENTIAL GUIDE TO INHERITANCE TAX

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INTRODUCTION TO INHERITANCE TAX

Inheritance tax used to be the preserve of only the wealthiest individuals in society.

Originally conceived in 1894 by the Liberal Party as Estate Duty, the tax was designed to repay a £4m government deficit and was targeted at those with wealth exceeding £100 on which a 1% tax would be levied. The tax was progressive and increased as the size of the estate increased rising to a maximum of 8% on estates worth over £1m (in what some would argue was a much fairer system than the 'cliff edge' we have now).

To put this into context, £1m in 1894 would be worth around £119m today. The tax has evolved over the years into what is now called Inheritance Tax (officially abbreviated by HMRC as IHT to avoid confusion with Income Tax). The current system sees a tax charge of 40% levied on estates worth over £325,000 (£650,000 for married couples/civil partners), with some estates benefitting from a tax-free allowance as high as £1m from 2020/21 (more on this later).

As a result of these successive changes, far more people are being pulled into the grasp of inheritance tax each year, with the most recent figures from the Office for Budget Responsibility (OBR) reporting a total inheritance tax take of around £5.2 billion on approximately 25,000 estates in the 2017/18 tax year – a £400m increase on the year before.

This figure is set to increase further still as a result of a largely static tax-free allowance and rising property and asset prices. The OBR predicts that the inheritance tax take will rise to £6.3 billion by 2024.

Given the huge impact inheritance tax can have on hard earned family wealth, it is no surprise that more and more people are looking to take sensible action to mitigate their liability and protect their assets for future generations.

In this brief guide, we will consider some of the planning tools we have available to reduce your inheritance tax liability and also think about how you can protect your assets from the other big threats to family wealth such as divorce, bankruptcy and spendthrift beneficiaries.

INHERITANCE TAX BASICS

Although you may be familiar with the basic operation of inheritance tax, it's always useful to have a refresher, especially when it comes to the new 'family home allowance' (officially called the Residence Nil Rate Band) over which there is a lot of confusion and misinformation.

Inheritance tax is charged on the estate of someone who has died (and on a select few lifetime transfers of assets). Before inheritance tax is charged, you are allowed to deduct any exempt amounts from the estate total. Anything that is not exempt is charged inheritance tax at a rate of 40%.

The basic Nil Rate Band (NRB) is currently £325,000 and it has been this way for just over a decade. The NRB is the standard inheritance tax free allowance that you can leave on your death. Each individual has a NRB and so for a married couple, you have two allowances giving a total tax free amount of £650,000.

When the first to die in a marriage or civil partnership leaves all their assets to the survivor, they pass free of inheritance tax (this is known as the inter-spouse exemption) and the survivor can 'inherit' their unused NRB, which is how you arrive at the above position with £650,000 of tax-free allowance.

As such, if we have a married couple with total assets of £650,000 and one of them dies and leaves everything to their spouse, the survivor now has the full £650,000. When the survivor dies, they can leave their full £650,000 estate free of IHT (assuming they did not make any gifts within 7 years of their death – more on this later).

In addition to the Nil Rate Band, we also now have the Residence Nil Rate Band (RNRB). This is a new allowance that was introduced by the Conservative government in 2017 in an attempt to reduce the IHT burden on increasing property prices.

The RNRB is a complex allowance with all sorts of caveats and exceptions attached, so it is important to make sure you have a full understanding.

The RNRB is £150,000 in the 2019/20 tax year and will increase to £175,000 in April 2020. From April 2021 onwards, the allowance (and the standard NRB) is expected to increase each year in line with inflation.

In order to benefit from this new allowance, there are a number of criteria that must be met as follows:

- You must own a family home at the time of your death. This is defined as the home that is your main residence or a home that you still own that was your main residence in the past. There are special protections for people who downsize or sell their property to go into care for example (as long as the sale took place on or after 8 July 2015).
- Your family home must be left to 'direct descendants', broadly defined as children and grandchildren.
- Your estate must be worth more than £325,000 (single) or £650,000 (as a married couple) in order to need to claim the new allowance (otherwise you are covered by the normal tax free amount).
- If your estate is worth over £2m, the Residence Nil Rate Band starts to get tapered away on a 2:1 basis. Meaning that for a single person, in 2020/21 the RNRB is lost when the estate exceeds £2.35m and £2.7m for a married couple.

As a result of the above rules, it is thought that relatively few estates will qualify. This is because in order to claim the new allowance you need to own your current or former family home (many people don't own a home), your estate needs to be over £650,000 as a married couple (£325,000 single) and under £2.7m (£2.35m single) in 2020/21 and you need to have children or grandchildren to pass the property to.

While the Residence Nil Rate Band is ultimately a welcome addition to the IHT landscape, its implementation is needlessly complex and many people will be ineligible to claim. As such, it is more important than ever to ensure that your estate planning is in order to maximise the benefit of this valuable allowance.

The remainder of this guide will consider a number of strategies that you can use to mitigate your IHT liability, starting with the humble will.

WRITE A WILL

A will is the most basic estate planning tool we have available. A will serves a number of purposes, but at the most basic level, it is a tool to ensure that your wishes will be carried out when you have gone.

If you die without a will, you are said to have died 'intestate' and, in effect, the government will decide who gets your money in this situation.

As such, a will is a must for anyone even remotely concerned about their estate planning. A will can also be used to begin implementing planning to reduce your IHT liability.

Statistics from the Law Society suggest that over half of people over the age of 45 have not made a will. This is all the more shocking when you consider that people in this age bracket often have significant financial assets and property wealth.

Although a will is always something that is tempting to put off, we encourage people to put a will in place as soon as possible.

A will can be instrumental in reducing your IHT liability, especially with the introduction of the new Residence Nil Rate Band. If your current will was drafted before the introduction of the RNRB in 2017, it would be a good idea to get this professionally reviewed to ensure you are making the most of this valuable new tax allowance.

LIFETIME GIFTING

Making gifts during your lifetime can be one of the simplest and most effective ways to reduce your inheritance tax liability.

Some lifetime gifts are covered by a range of exemptions and others are known as either 'Potentially Exempt Transfers' (PETs) or 'Chargeable Lifetime Transfers' (CLTs).

If possible, it is always good to make full use of some of the basic IHT exempt gifting allowances and we are going to consider three of the most useful exemptions in the following sections:

THE ANNUAL EXEMPTION

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 and must also fully use the current year's allowance.

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.

THE £250 'SMALL GIFTS' EXEMPTION

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 £250 or less 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.

GIFTS OUT OF REGULAR INCOME

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, as 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. 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 to fund the gift, you should be OK. It is also worth mentioning that most gifts to UK registered charities and major political parties are exempt from IHT and there is no limit to these exemptions.

If you are looking to make larger gifts (having already used any possible exemptions above), then the gift will most likely be classed as either a PET or a CLT:

POTENTIALLY EXEMPT TRANSFER (PET)

This is the term given to a gift that is potentially exempt from inheritance tax.

In broad terms, this will apply to gifts you make to individuals and bare trusts. The gift is known as potentially exempt because, if you do not live for seven years after having made the gift, the amount is pulled back into the calculation for inheritance tax. If you survive for seven years after making the gift, then it will fall completely outside of your estate and no inheritance tax will be due.

For example, if you made a gift of £100,000 today and then died 4 years later (assuming no other gifts before or after), then the £100,000 would be pulled back into your IHT calculation. Any lifetime gifts are usually set against your Nil Rate Band first and so the gift would pass tax-free, but this would leave just £225,000 of your £325,000 allowance remaining for the rest of your estate.

CHARGEABLE LIFETIME TRANSFER (CLT)

This is the term given to gifts that are chargeable during your lifetime. This will usually apply to gifts made to most types of trust (apart from bare trusts).

Although called chargeable transfers, in practice a charge will only apply if the value of chargeable transfers within the past seven years exceeds your available nil rate band. For this reason, it is rare to make chargeable lifetime transfers of more than £325,000 per person (£650,000 for a married couple) during each seven-year period.

As with PETs, CLTs will fall out of the estate following a 7 year survival period although they can still have an impact on later gifts for up to 14 years after being made.

By using a carefully considered combination of PETs and CLTs it is possible to remove very substantial amounts from your taxable estate, however you should always ensure that you can afford to make those gifts before handing over the money – once money has been gifted, you cannot take it back (otherwise the gift will not be effective for IHT purposes).

USING TRUSTS

Trusts have a variety of functions in family estate planning and have been used for hundreds of years as a method of passing wealth down through the generations in a structured way, while also protecting the estate from many other threats to family wealth.

Trusts can also play a major role in reducing an inheritance tax liability.

Lifetime gifts can be channelled into trust to generate tax savings (after a 7-year period) while also allowing the donor to retain some control over the assets in question.

Trusts can also be used on death to receive assets to reduce the IHT liability of future generations, while also protecting the assets from common threats such as the divorce or bankruptcy of a beneficiary.

WHAT IS A TRUST?

In simple terms, a Trust is the donation of an asset by an individual (the settlor) to other individuals (trustees) for the benefit of others (beneficiaries). The role of the trustee is crucial in administering the Trust, and can be anybody over 18, of sound mind and not bankrupt. Both the settlor and a beneficiary of the trust can act as a trustee.

While there is nothing that prevents a settlor being named as a beneficiary, this will negate many of the benefits of setting the Trust up in the first place and in almost all circumstances should be avoided.

In legal terms, there are two main types of Trusts – those with an enforceable interest and those with a prospective interest. Trusts with an enforceable interest will have clearly defined beneficiaries and include Trusts such as:

- **Life Interest Trust –** one person has the right to income for their life (life tenant), and others (the remaindermen) are entitled to the capital on the death of the life tenant.
- **Flexible (or Power of Appointment) Trust –** the Trust has two classes of beneficiaries (actual and potential) and the trustees have the power to replace an actual beneficiary with somebody from the list of potential beneficiaries, for example if the actual beneficiary has passed away.
- **Bare (or Absolute) Trust –** a beneficiary has an immediate and absolute entitlement to both capital and income which cannot be revoked.

The main type of Prospective Interest Trust is a Discretionary Trust which is similar to a Flexible Trust but differs in that it has no actual beneficiaries i.e. all of the beneficiaries are potential beneficiaries only. This gives the trustees full flexibility to decide who benefits from the Trust, as well as controlling how much they will receive and when payment is made.

The wide ranging flexibility available to trustees within a Discretionary Trust means that there are very few circumstances in which the Trust assets could not be distributed to a beneficiary of some description, and almost all Trusts used in relation to financial planning are set up as Discretionary Trusts.

Various options exist when considering assets to be transferred into Trust and the options will depend on whether or not the asset produces an income.

WHY SHOULD I USE A TRUST?

The primary use of Trusts for bloodline planning is to retain as much of the estate as possible for direct family members. They seek to protect assets from attack from scenarios such as:

DIVORCE AND REMARRIAGE (BLOODLINE PROTECTION)

Many people whose spouse has passed away will get remarried but many of these second marriages will end in divorce. If assets have been inherited directly by the surviving spouse, then up to 50% of this inheritance could be lost on divorce.

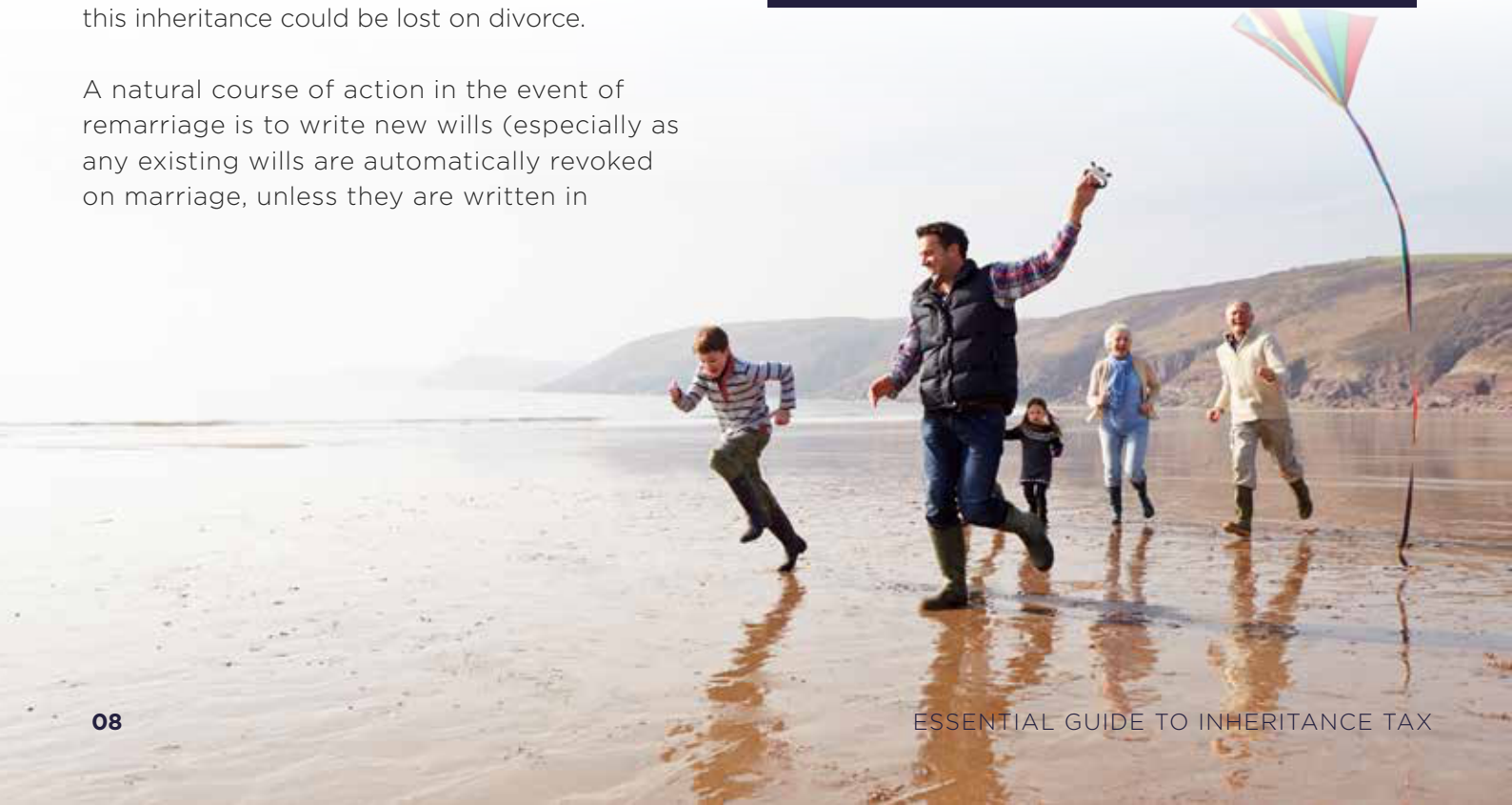
A natural course of action in the event of remarriage is to write new wills (especially as any existing wills are automatically revoked on marriage, unless they are written in contemplation of marriage), but unless great care is taken in creating these wills, all of the assets from the first marriage could be lost to the offspring of this relationship.

EXAMPLE

David and Lisa are married and have two sons – they both created wills which named their spouse as the sole beneficiary of their estates, and assets to pass to both children if they were to both die.

David passes away in his early forties and Lisa receives all of his assets including his share of the family home. After a few years, she meets Leon and they get married – Leon has two daughters and they agree to create new wills nominating the other in the event one of them should pass away, and for their joint estates to be split equally between all four children on second death.

Ten years later, Lisa passes away and Leon receives all of Lisa's assets including the money that she had inherited from David. Leon and the two boys have always had an uneasy relationship, and during the probate process they have a falling out – Leon then changes his will to leave everything to his daughters meaning that Lisa and David's children will not receive a penny from the assets that their parents built up during their lives.



INHERITANCE TAX EFFICIENT INVESTMENTS

Although certainly not right for everyone, there are a variety of investments that qualify for some type of IHT relief or exemption (and often other tax incentives as well).

It is important to make sure that the 'tax tail is not wagging the investment dog' – you should never invest in something inappropriate for your circumstances just to obtain a tax incentive. There are 3 main types of investments available to mainstream investors that offer some kind of IHT incentive:

AIM SHARES

These are simply company shares traded on the AIM (Alternative Investment Market), which is the junior part of the London Stock Exchange.

There are currently around 1,000 companies listed on the AIM and these range in their size, scope and risk profile.

AIM shares are arguably the simplest of the business property relief qualifying investments, as there are no other tax rules to worry about. You can purchase AIM shares, hold them for two years and then they should become exempt from inheritance tax.

However, AIM shares can be very volatile. At the time of writing, the biggest faller on the day is down by 20% and one company has risen by 80% in a day! Therefore, a portfolio approach is often best when investing in AIM shares to iron out some of this short-term volatility. It is thought between 20 and 50 stocks is sufficient to create a good level of diversification.

The main issue with AIM shares as an inheritance tax planning strategy is that, at some point, they might stop being AIM shares. This can happen for a number of reasons: the company might grow quickly and then decide to list on the main stock exchange, or the company could go bust or simply stop meeting the qualifying criteria to be listed on the AIM.

If this happens, the inheritance tax benefits will be lost, so it is important that any AIM portfolio is kept under constant review to ensure that it remains inheritance tax efficient. For this reason, I suggest that all but the most experienced investors (with lots of time on their hands) are best placed to use one of the many professional AIM portfolio managers to look after their shares for them.

AIM shares can be illiquid or infrequently traded, but they do tend to be the most liquid of the inheritance tax efficient investments, as you will see in just a moment.

ENTERPRISE INVESTMENT SCHEME (EIS)

The Enterprise Investment Scheme was created by the government to allow small and early-stage companies to raise growth capital from private investors.

Over the years, the type and size of company that can qualify for EIS have changed, but generally the firms will be on the smaller end of the spectrum.

EIS investments in qualifying companies can come with a whole variety of tax benefits:

- You get 30% income tax relief on up to £1 million of investment each year. For example, if you invest £10,000, you should receive £3,000 in income tax back.
- Any gains made from the shares are exempt from capital gains tax once they have been held for three years.
- You can defer paying capital gains tax on other assets if those gains are invested into EIS investments within certain time limits.
- There is further income tax relief if the investments lose value.
- Finally, and perhaps most importantly for you, EIS investments will generally qualify for business property relief after a two-year holding period and thus be exempt from inheritance tax. Now, all of these tax benefits might sound truly attractive, and they are; however, they are offered for a reason. EIS investments tend to be in early-stage, unquoted companies.

This means that the shares are generally illiquid – they can't usually be sold on the open market. As such, you are hoping that the firm eventually lists on the stock market or is sold in the future for a profit.

EIS investments are also risky, and some of these early-stage companies can, and do, fail completely, meaning that you have nothing left of your investment.

SEED ENTERPRISE INVESTMENT SCHEME (SEIS)

The Seed Enterprise Investment Scheme (or SEIS) is for even smaller companies. The rules and tax breaks are similar to EIS investments, although you can obtain a 50% income tax relief on the initial investment. SEIS investments are riskier still when compared with EIS and so even more care is required.

As with all other investments, EIS and SEIS can provide some attractive investment opportunities and have the potential for spectacular returns, but care is needed. You should always do your homework and, if you are unsure, speak to a qualified Independent Financial Adviser and get good-quality personal advice.

INSURANCE SOLUTIONS

There are also a few insurance solutions that can be used to manage your IHT liability.

While most people think of life insurance in terms of repaying their mortgage if they die, a special type of life insurance, Whole of Life cover, can be used to pay an IHT liability.

A Whole of Life policy does what the name suggests – it is a life insurance policy that covers you for your whole life and pays out a lump sum when you die, so long as you keep up with the premiums.

Although the cost of Whole of Life cover can be significant and will depend on your age and health, the lifetime cost of a Whole Life policy can be significantly less than the IHT liability it is designed to cover, thus allowing you to pay off the IHT bill at a substantial 'discount'.

It is imperative that any policy is written into trust to make sure it does not fall into your estate, otherwise you risk making the IHT problem worse and not better.

The other advantage of life insurance is that it provides a lump sum of capital that can pass to beneficiaries outside of the probate process and so these funds are available very quickly (usually within a matter of weeks, rather than the 6-18 months and beyond it can take to go through probate).

PASSING ON YOUR PENSIONS

Following on from the pension reforms in April 2015, money purchase (defined contribution) pensions now present a very interesting estate planning opportunity.

Under the new regime, if an individual dies with liquid pension assets and they are under 75, these benefits can be left to any individual tax-free.

If the individual dies over age 75, then any beneficiary can still be nominated, however they will then pay their marginal rate of income tax on any benefits drawn from the pension. Despite income tax being chargeable, the tax rates paid by beneficiaries could still be significantly below the 40% rate of IHT.

As a result of these new rules, careful consideration should be given to how your pensions fit into your overall estate planning. It may be best to spend other assets and thus preserve your pension as a tax efficient vehicle to pass onto your loved ones.

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.

BOOK YOUR DISCOVERY MEETING

Buckingham Gate Chartered Financial Planners offer a 1-1 discovery meeting with a chartered financial planner. If you would like to see how we can add value to your personal situation, please get in touch by emailing **contact@buckinghamgate.co.uk** or calling **0203 478 2160**.

"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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