PRIVATE FUND
MANAGEMENT

GUIDE TO **INHERITANCE TAX**

Inheritance tax (IHT) was traditionally regarded as a tax only for the very wealthy. However, with a threshold of £325,000 (£650,000 for married couples and civil partners) that will remain frozen until 2021, and the price of houses still relatively high, more and more people could find themselves caught in the net. This could force many people to sell family heirlooms or investment assets to meet tax bills that a little bit of planning could have helped to avoid. This guide is designed to help you through the maze of IHT, outlining who needs to be concerned, explaining how IHT works and introducing some of the allowances that can help to mitigate its effects on your estate. If you would like to discuss any of the points raised, please do not hesitate to contact us.

WHAT IS INHERITANCE TAX?

Inheritance tax is payable when someone transfers ownership of their assets, usually on death. Each individual is entitled to a nil-rate band of £325,000, under which no inheritance tax is payable. Traditionally, few estates exceeded this nil-rate band.

However, the house price boom of recent years has pushed more people into the IHT net. Alongside ISAs, death-in-service benefit, foreign homes or less obvious assets such as paintings or cars, this has boosted the value of an average estate.

The tax rate for all assets over the nil-rate band is 40% so it is possible to build up a large bill quickly. Also, inheritance tax becomes payable relatively soon: it is due six months after the end of the month of death.

This does not give the administrators much time to sell a house or liquidate other assets if that is necessary. With that in mind, if you unexpectedly find your estate now exceeds the taxman's limits, what can you do?

Although the Government closed many of the loopholes on inheritance tax in the 2006 Budget, a number of exemptions and allowances do remain. Where possible, you should aim to maximise use of these exemptions and allowances if you wish to pass on as much of your hard-earned cash to your heirs as possible.

EXEMPTIONS AND ALLOWANCES

In addition to the £325,000 nil-rate band available on each estate, transfers between husband and wife or between civil partners are free of tax. Since 9 October 2007 , such legally recognised partners can also pass over any unused portion of their own nil-rate band so that, in effect, the surviving spouse has up to £650,000. However, this does not apply to cohabiting partners or 'common-law' spouses.

Moreover, an additional, transferable nil-rate band is being phased in, starting in April 2017. This enables individuals to pass on their main residence to direct descendants – such as a child or grandchild – without incurring IHT. This allowance is up to £100,000 in 2017/18, rising to £125,000 in 2018/19, £150,000 in 2019/20, and £175,000 in 2020/21. When added to the existing nil-rate band of £325,000, this creates an IHT threshold of £500,000 for estates by 2020/21. Any of this unused allowance can be transferred to the surviving spouse or civil partner, raising the effective IHT threshold to £1 million by 2020/21; moreover, homeowners who opt to downsize will not lose their allowance. However, estates with a net value of over £2 million will suffer a tapered withdrawal of the main residence nil-rate band.

The majority of other exemptions and allowances come about through distributing some of your wealth prior to death. Such assets transferred prior to death are termed 'potentially exempt transfers' (PETs) for IHT purposes and they are potentially exempt because, from the day you give them away, the tax due on death is subject to a tapering over seven years, starting at 100% of liability for the first three years, then falling proportionally from 80% over the next four. If you survive the full seven years, the IHT liability on that asset becomes zero.

However, this taper relief only applies to amounts in excess of the nil-rate band. As there is no tax due on the first £325,000, then no taper relief can apply. Therefore, if you give away anything up to £325,000 and die within those seven years, the full amount of the original gift will be added back into your estate and tax will be calculated on the total as if you never gave that amount away.

Having said that, if you do survive seven years, then that amount is considered as having left your estate and you therefore get the chance to benefit from the nil-rate band allowance a second time.

There is an important restriction on PETs called a 'gift with reservation of benefit'. The principle is that, if you continue to enjoy the benefit of an asset, the transfer is entirely ineffective for inheritance tax purposes. This is in place to stop parents, for example, transferring their homes to their children and continuing to live in them. In order for such a transfer to be potentially exempt, a full market rent would have to be paid to the children after transfer.

IHT ON GIFTS

Gifts of £3,000 or less are allowed annually without being liable for IHT – and, if unused, this allowance can be carried forward for one year. There is also a gift exemption applying to 'regular gifts out of income'. These gifts can be as much as you like, but they must form part of a 'pattern of giving' and HM Revenue & Customs must be satisfied that, after the gift has been made, you are left with sufficient income to maintain your existing standard of living.

You are also allowed gifts on consideration of marriage or civil partnership. The amounts vary according to your relationship to the bride and groom; at the moment, £5,000 is allowed from the parents, £2,500 from the grandparents and £1,000 by anyone else. Gifts to charities also fall outside inheritance tax.

TAKING PRACTICAL STEPS

"MAKING A WILL IS VITAL. IF YOU DIE 'INTESTATE' (WITHOUT A WILL), YOUR ESTATE WILL BE DIVIDED UP ACCORDING TO THE RULES OF INTESTACY. "

You can take some basic steps to ensure that you make full yet practical use of your allowances and exemptions. Planning ahead is very important and, if in doubt, always take professional advice.

STEP ONE – THE BASICS

Making a will is vital. If you die 'intestate' (without a will), your estate will be divided up according to the rules of intestacy. This is particularly important if you are not married, because you would be unlikely to inherit a 'common-law' partner's money, or even their share of your house. For example, under the laws of England & Wales (the Inheritance and Trustees' Powers Act 2014), your legal spouse or civil partner receives the personal chattels and £250,000 plus half of the remainder of the estate and the balance is divided equally amongst your children . If you have no children, your spouse/civil partner will inherit the entire outstanding estate. If you have no spouse/civil partner, it will pass to your children or their descendants. If you have neither spouse/civil partner nor children, your parents will inherit, followed by your siblings, then your grandparents, then your uncles/aunts, or finally your cousins. If you have no legally recognised family, it goes straight to the Crown.

Please note, the intestacy rules in Northern Ireland are similar to these, however, the rules

are quite different in Scotland. Here, the intestacy laws are governed by the Succession (Scotland) Act 1964, which makes the situation a little more complicated. Always check with a professional adviser to understand how the laws apply in your location.

STEP TWO – USE YOUR ALLOWANCES

The basic allowances available have already been briefly outlined. Considering how you can use these in advance will help you manage the assets and any cash flow associated with a 'pattern of giving'. In addition, if you can start giving away some of your assets as PETs when you are still in robust health and likely to live another seven years, it will save you worry later on.

STEP THREE – USING TRUSTS

For many years, trusts were viewed as an easy way to brush off an inheritance tax liability. If this were ever the case, it certainly was not after the 2006 Budget. This closed down many of the tax planning opportunities for investors and interest in possession (IIP) trusts and accumulation & maintenance (A&M) trusts became subject to the same IHT treatment as discretionary trusts.

Now, transfers into most IIP and A&M trusts over the donor's nil-rate band are subject to an up-front 20% IHT charge. These trusts are also liable to a periodic charge every ten years and an 'exit' charge when funds are taken out of the trust. If a donor puts money into one of these trusts, they pay the 20% tax on any amount above the nil-rate band. If they die within seven years , they are liable for the balance of IHT due. However, if they survive seven years, the donor will have the chance to use their nil-rate band again.

STEP FOUR – CONSIDER LIFE ASSURANCE

Life assurance can be a useful way to accumulate enough money to pay your inheritance tax bill and, when placed in trust (and funded from regular income as part of a 'pattern of giving'), is also free from inheritance tax. This means that you do not create an additional IHT burden because the trust keeps that lump sum payment out of your estate. This can be particularly useful from a liquidity point of view, as the lump sum will be readily available to your beneficiaries to pay the taxes while the estate itself is being unwound.

"LIFE ASSURANCE CAN BE A USEFUL WAY TO ACCUMULATE ENOUGH MONEY TO PAY YOUR INHERITANCE TAX BILL."

OTHER INHERITANCE TAX-PLANNING TOOLS

DISCOUNTED GIFT PLANS

Discounted gift plans are basically investment bonds, wrapped in a trust and designed to minimise, although not eliminate, IHT liabilities. You can put a lump sum into a plan and then take out up to 5% of the capital tax-free each year.

At the point at which you put money into the plan, a designated discount rate decides how long you are likely to live, how many years the 5% is likely to be paid out, and therefore how much of the trust is 'yours' and forms part of your estate.

The remaining assets, including any growth, are free from tax provided you survive for seven years. However, these schemes do depend on having disposable cash, a need for income, and a reasonable expectation of surviving the full seven years.

INVESTMENTS PROVIDING TAX RELIEF

The value of most investments will be subject to inheritance tax, including ISAs, property, art, wine and foreign property. However, a number of investments can qualify for IHT reduction or relief. For example, if you have held shares in an Enterprise Investment Scheme (EIS) for more than two years, it will fall out of your estate for inheritance tax purposes.

However, an EIS involves investing your money into unquoted companies and you therefore run a higher risk than other investments of losing some or all of the value. Consequently, you need to be certain that you are comfortable with this additional risk before considering the IHT benefits. Ultimately, paying out 40% of something is better than saving 40% of nothing.

Notwithstanding this, if you are a business owner, the benefits may help you to pass on your own company, providing it meets the criteria. There are also two types of tax relief available for investments into business or farming: business relief and agricultural relief.

SUMMARY

Inheritance tax is no longer the 'voluntary' tax it was once considered. However, careful planning to ensure you take advantage of all the allowances and reliefs available could save you a lot of money relatively easily. It is never too early to start.

We hope you found the information in this guide useful and informative. If any of the points are of interest, or you would like to discuss your own situation in more detail, please get in touch.

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