GUIDE TO INHERITANCE TAX

Inheritance tax (IHT) has traditionally been seen as a tax only for the very wealthy. However, with a threshold of £325,000 (£650,000 for married couples and civil partners) and the price of houses still relatively high, even after recent corrections, more and more people are finding themselves caught in the net. This could lead to many people having to sell long-held family heirlooms or investment assets to meet tax bills that a little bit of planning could help avoid.

This guide is designed to help you through the maze of IHT, outlining who needs to be concerned, explaining how it works and introducing some of the allowances you can use to help 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, under which no inheritance tax is payable. Traditionally, very few estates have exceeded this nil rate band.

However, despite recent corrections, 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. Indeed, even after the housing market started to fall in 2007, the Treasury's 2008/09 receipts from IHT payments were still up 20% on 2002/03

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 quickly. It is due six months after the end of the month of death. This does not give the administrators much time to, say, 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 as much of your hard-earned cash onto your heirs as possible.

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 cohabiters or 'common-law' spouses.

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 in to 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.

However, 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 – and if anything were to happen that affected the children's financial position, parents could find that the house would need to be sold.

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 the Inland Revenue 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

"CAREFUL PLANNING TO ENSURE YOU TAKE ADVANTAGE OF ALL THE ALLOWANCES AND RELIEFS AVAILABLE COULD SAVE YOU A LOT OF MONEY RELATIVELY EASILY."

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 Administration of Estate Act 1925), your legal spouse or civil partner, along with the personal chattels, receives £250,000 and a life interest in half the remainder of the estate and your children will get the balance at 18. If you have no children, £450,000 plus a life interest in half the remainder passes to your spouse/civil partner with the chattels and the remainder to your parents or siblings. If you have no spouse/civil partner, it will pass to your parents or then your siblings. If you have no legally recognised family, it goes straight to the Crown.

Please note, in Northern Ireland, the intestacy rules are similar to these, however, in Scotland, the rules are quite different. 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

Trusts have long been 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 under the new regime, 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 of up to 6% every 10 years and an 'exit' charge when funds are taken out of the trust. However, despite their diminished tax advantages, these trusts are still useful because they allow for the 'regeneration' of the nil rate band every seven years.

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, designed to minimise, although not eliminate, IHT liabilities. You can put a lump sum into a plan and then take up to 5% of the capital out 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 providing you survive 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 property relief and agricultural property relief.

SUMMARY

Inheritance tax is perhaps no longer quite 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.

contact

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.

Produced by adviser-hub.co.uk on behalf of your professional adviser.

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