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Guide to Inheritance Tax Planning

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Inheritance Tax Planning – Your Options

What is Inheritance Tax and How does it Work?

Inheritance Tax (IHT) is a tax calculated on death, based on the total value of all your estate's assets. Funds from your estate and / or money raised from the sale of estate assets are used to pay any IHT due to HM Revenue and Customs (HMRC). This usually happens prior to the assets being transferred to the beneficiaries.

The tax rate is 40% and this is levied on all assets at death that exceed HMRC allowances known as "nil rate bands" (NRB). Since April 2009 the nil rate band has been £325,000 for each of us, and it is not currently set for review until April 2028.

Married couples and civil partners can, however, transfer assets to each other whilst they are alive, or on death without triggering an IHT charge, which means that for many, IHT will only be charged when the last survivor in a couple passes away. It is also possible to claim any remaining Spouse's / Civil Partner's nil rate band when they die, meaning that the survivor may well have up to £650,000 (2 x £325,000) of nil rate band to set against their estate.

In addition to the nil rate band, the government introduced the residence nil rate band (RNRB) which became available to claim from the 2017/18 tax year. The maximum RNRB allowance is £175,000 and relates to the value of a single main residence that is being left to a direct descendant* on death. The unused RNRB from a deceased spouse / civil partner, much like the NRB, can also be claimed by the survivor, meaning that up to £350,000 (2 x £175,000) of RNRB may be available to the estate on second death.

The rules around the RNRB are complex and advice should be sought to check if you will qualify. For some couples the combined NRBs (£650,000) and RNRBs (£350,000) can result in up to £1m of assets passing to beneficiaries on second death without a charge to IHT.

**Child, stepchild, adopted child, foster child.*

How can I mitigate IHT?

Here are five ideas that may help; don't hesitate to ask us if you would like us to chat any of them through in more detail -

1 Spending

Spending money on experiences such as holidays, day trips, meals, or anything else that doesn't involve the purchase of an asset will reduce your estate value, thereby saving IHT when you die. It is important to make sure that you retain an emergency fund and capital to help fund needs in the future such as monies to fund care. But beyond that, enjoying your money not only improves your quality of life but also reduces the tax payable when you die. Many clients unduly worry about running out of capital in later life, we can help by calculating an appropriate spending budget, ensuring you enjoy your life as much as possible without worrying about leaving yourself short in the future.

2 Gifting

a) Annual gifting allowance

You can make gifts totalling up to £3000 each tax year and these gifts will be immediately exempt for IHT purposes. You can also carry over any unused exempt amount from the last tax year (one year max) , so up to £6000 could be given away in a single year with immediate impact in reducing IHT. This is one of the simplest and quickest ways of reducing IHT.

b) Wedding / Civil Partnership Ceremonies

There are also special exempt gifts in consideration of wedding / civil partnership ceremonies. You can give £5000 to a child, £2500 to a grandchild or great-grandchild or up to £1000 to anyone else who is getting married / entering a civil partnership.

c) Small gifts

You can make small gifts of up to £250 each to as many individuals as you like in any one tax year. Gifts in excess of £250 do not qualify and you can't use the small gifts allowance in conjunction with any other exemption when gifting to the same person.

d) "Normal expenditure out of income" regular payments

A little known but valuable exemption. You can make regular payments out of your surplus income and the gifted income leaves your estate for IHT

purposes immediately. There is no limit to how much you can give tax free, as long as:

- you can afford the payments after meeting your usual living costs, i.e., without reducing your standard of living.
- you pay from your regular monthly income and not from capital.

It is important to take advice if you are planning to take advantage of this exemption as accurate record keeping is essential and the rules can be complex and easy to misinterpret.

e) Potentially Exempt Transfers (PET) & The Seven Year Rule

Gifts to other individuals or to bare/absolute trusts that fall outside the exemptions above are known as potentially exempt transfers (PETs). If you survive for a seven-year period after making a gift to someone, then the gift will be exempt from IHT. If you die within seven years of making a PET and the value of all PET gifts is less than the available Nil rate band, then the gifts are added back into your estate and any tax due is paid from the estate assets. However, if the PETs exceed the Nil rate band then IHT will need to be paid by the gift recipient or the representatives of the estate. Gifts made over the value of the available nil rate band may benefit from "taper relief", a downward sliding scale within the seven years that can reduce the percentage IHT payable on the gift. It is therefore very important to record the date, value and recipient of any gift so that accurate assessments can be made if you die within the seven years.

Years between gift and death	Rate of tax on the gift
0-3	40%
3-4	32%
5-6	16%
6-7	8%
7 or more	0

Finally on gifting, a brief note of caution. For a gift to be effective for IHT mitigation, it is important that the gift is made outright and that you do not continue to derive a benefit from the asset that you have given away. If you still enjoy a benefit from the gifted property this is deemed to be a "gift with reservation" and the full value of the gifted asset will be brought back into

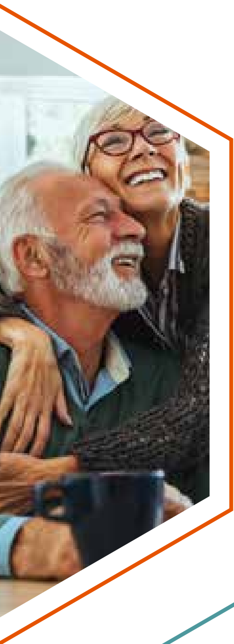
your estate for IHT purposes. A common mistake for example, is to transfer the ownership of your home to your children as a "gift" for IHT purposes, but then continue to live in the property whilst paying no or only a nominal rent. In these circumstances the full value of the property is likely to be added back into the estate value and taxed accordingly on death, making the planning and transfer totally ineffective for IHT mitigation purposes. This strategy also exposes you to the whims of your landlord children and presents further ownership challenges if they were for example to divorce in the future.

3 Trusts

Trust planning is often used where someone wishes to make a gift for IHT mitigation purposes, but they want to exert some degree of control over how and when the gifted capital and / or income is paid out to the chosen beneficiaries. Direct gifting as we discussed above can be simple and effective but as soon as the gift is made, the gifted property it is no longer yours and the cash / proceeds can be spent however the recipient chooses. The directly gifted capital could also be diverted into unplanned hands in circumstances such as business failure or divorce and so ultimately there is no controlling where the proceeds might actually end up.

A trust is a legal entity designed to manage assets in line with the gifter's wishes and can be effective in controlling the ultimate destination of the capital over time. Trusts involve -

- the 'settlor' - the person who puts assets into a trust and decides how they would like the assets to be used, usually via a document known as the trust deed.
- the 'trustee' - the person who manages the trust, nominated by the settlor as someone trusted to follow their wishes for the trust property into the future.
- the 'beneficiary' - the person who benefits from the trust



In general, a gift into trust (other than into a bare trust or vulnerable beneficiary trust which would be a PET as described above), would fall fully out of the estate value calculation for IHT purposes after a seven-year period, although gifts that exceed the amount of the available nil rate band can trigger an immediate IHT charge in some forms of trust. Trusts can hold investments to grow capital or produce an income for the future in order

suit the settlor's wishes and beneficiaries' needs. There are a number of different trust structures depending on the needs of the settlor. Some trusts facilitate settlor access to some of the trust capital / income, if for example they needed extra cash for residential or nursing care, or to cater for other unforeseen eventualities. Other trust structures allow you to loan capital into the trust so that only the profit from the loaned capital falls into immediate trust ownership, the remaining loaned monies being fully available to the lender should they ever be required.

Trust planning can be complex, with each trust structure having differing features and tax treatment. It is important to seek professional advice in this area to make sure arrangements are effective and appropriate for your needs.

4 Business Relief (BR)

Business relief was introduced in the 1976 Finance Act, originally as a mechanism to keep family businesses trading following the death of the owners. The cash flow impact of a business having to raise money for inheritance tax meant that many were forced to cease trading, which was ultimately harming the economy and dis-incentivising entrepreneurs. The introduction of business relief meant that owners who died owning shares in their trading business, having held them for at least a two-year qualifying period, exempted the share value for IHT.

Today a number of packaged IHT investment portfolios and products utilise this relief to reduce the IHT bills for private clients who choose to invest in qualifying companies.

Common underlying investment sectors within these portfolios / products include –

- Sustainable energy – Wind, Solar, Bio-digestion.
- Secured Lending – secured lending to businesses for commercial property development or project investment.
- Alternative Investment Market shares (AIM) – shares in qualifying businesses listed on the AIM market, a sub-market of the London Stock Exchange (LSE) that is designed to help smaller companies access capital from the public market.

The potential advantage of such investment is that you retain control and access to your capital, as there are no gifts involved. The investment accounts are set up in your name and in many cases, you can make withdrawals (subject to the liquidity of the underlying trade) if you need money out in the future. The two-year qualification period is also much shorter than the seven-year qualification for gifts.

Some providers also offer insured options that pay out a lump sum equivalent to the IHT due on the investment value were you to pass away during the two-year qualification window. Meaning that IHT is effectively mitigated immediately, there are, however, cost implications to consider.

Business relief investment is high risk and professional advice should be taken to determine whether this is a suitable route for you to mitigate IHT.

5 Whole of Life Insurance

A whole of life insurance policy can be used to provide funds to the beneficiaries of an estate so that they can settle the IHT liability, without having to sell or draw on the estate assets to do so.

This is particularly useful when an estate holds property assets that the beneficiaries want to retain e.g., a buy to let property or main residence. Without other reserves, beneficiaries may face the prospect of having to sell a property within the estate to generate sufficient cash to pay the IHT.

A whole of life policy unlike a term insurance policy has no prescribed end date or "term". It is designed to provide a lump sum on death whenever that may occur. For married couples or those in civil partnerships policies are often set up on a "joint life second death basis" as it is frequently only on second death that an IHT liability is created.

The policy is usually written into a trust so that the policy proceeds aren't added to the deceased's estate on death, thereby creating a further IHT charge, but instead pays out to a trust outside the estate. On payment of the policy proceeds, the trust funds are immediately available to the beneficiaries, enabling them to draw the monies required to settle the IHT liability.

Insurers often require access to your medical records and, in some circumstances, conduct a medical assessment before the policies are costed and terms drawn up (underwritten). Premiums will vary dependent on your health and lifestyle as well as the sum assured. Insurers treat health conditions and client circumstances differently when assessing the required premiums, so engaging an adviser to carefully select the most appropriate insurer, and to tailor the policy to your exact requirements is essential.

Next Steps

As we have covered, there are many options available to you in mitigating inheritance tax, each with advantages and risks.

It is therefore vital that a full discussion of these options is conducted to ensure that the chosen strategy, which will likely involve more than one solution, best meets your individual circumstances and requirements.

WBW Chartered Financial Planners will be happy to talk through the pros and cons of each option and provide an independent, unbiased recommendation tailored to you.

Call us a for a free of charge initial discussion on **01626 242500**.

The information contained within this article is for guidance only and does not constitute advice which should be sought before taking any action or inaction. The information is based on our understanding of legislation, whether proposed or in force, and market practice at the time of writing. Levels, bases and reliefs from taxation may be subject to change.

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