PENSION MATTERS

A guide to INHERITANCE TAX

Contents

Introduction 3

What exactly is inheritance tax? 4

How much inheritance tax will my estate have to pay? 5

Key IHT allowances, reliefs and exemptions 6

Simple ways to reduce inheritance tax 9

Your home and inheritance tax 11

Wills and inheritance tax 12

Life assurance and inheritance tax 13

Long term care tax 14

Conclusion 15

Introduction

Selecting a partner in any walk of life is never easy, and made all the more difficult when you are looking to invest both financially and emotionally into the unknown.

It is so hard to judge the quality of a service that you cannot see or touch and you will only know if you have made the right decision many years down the line.

There are many ways that you can avoid or reduce your liability to pay inheritance tax. Some methods can be unnecessarily complex and it is important that take professional financial advice from an expert to help you to choose the right options for you, very often a few simple and cost effective measures involving wills and trusts can solve the problem.

We will be happy to discuss each option with you and explain how each one can save you inheritance tax. Our approach to reducing IHT liability is to reduce the value of your estate over a period of time. Put simply, the smaller the value of your estate when you die, the less your IHT liability will be.

We hope you find our guide of interest, but please note it is only a guide based on our understanding of current legislation. Before beginning any strategies designed to protect your assets against inheritance tax or long term costs we would strongly recommend that you seek professional advice – naturally we hope you choose us!

Paul

Paul Steel **BA (Hons), FCII, FPFS**
Chartered Financial Planner

What exactly is inheritance tax?

Inheritance tax is potentially charged on your estate when you die. It is a very simple but avoidable tax.

A tax charge of 40% is made on everything you possess above a certain financial threshold which is known as the Nil Rate Band (NRB).

When I say everything you own – I mean everything! It is charged against the net value of everything in your estate including your house, any holiday home or investment properties, cash savings, investments, National Savings, shares, cars, jewellery etc. Assessment will also include your car and other personal possessions plus the value of any life assurance policies that are not in trust.

I didn't know where to start regarding my pension arrangements and feel I received really good advice from Paul. He took the time to understand what I wanted to achieve and made the whole process very easy. ST, Jesmond

However rises in property values in the last 10 years and increased personal wealth mean that many more people own assets which are (or will be) valued well above the NRB threshold. Without the correct IHT planning your family could be faced with a very large tax liability when you die and one very important point to understand about inheritance tax is that **the tax MUST be paid before your estate can be released to your beneficiaries, that means none of your assets can be used to pay the tax,** the money will have to be found elsewhere by your children or nominated beneficiaries, this is usually done in the form a of a bank loan – not a thing you really want your children to be organising at such a stressful time.

However, with the correct planning this can all be avoided!

How much inheritance tax will my estate have to pay?

If you take no action to reduce your IHT liability and no there is unused NRB to transfer to you resulting from the death of your spouse or civil partner, the table below provides an indication of what your IHT liability could be:

By planning appropriately and making full use of the allowances available your IHT liability can be mitigated by legitimately reducing the value of your taxable estate.

Estate value	Amount taxable (2009/2010)	IHT payable at 40%
£300,000	£0	£0
£400,000	£75,000	£30,000
£500,000	£175,000	£70,000
£600,000	£275,000	£110,000
£700,000	£375,000	£150,000
£800,000	£475,000	£190,000
£900,000	£575,000	£230,000
£1,000,000	£675,000	£270,000

The more common approaches to reducing IHT include:

- **The efficient use of trusts** – a simple and effective way of reducing the value of your assets without losing control of them.
- **Ensuring assets are individually owned by family members up to the NRB threshold** – known as the equalisation of assets.
- **Putting a suitable will in place** – this ensures your estate is distributed in line with your wishes rather than those of the laws of intestacy.
- **Making full use of all allowances and exemptions** – ongoing planning to gradually reduce your estate.
- **The use of IHT efficient investments** – it is very important to consider planning well in advance, while you are still in good health. For example, if gifting assets, there is an IHT liability for 7 years from the date of making the gift.

Key IHT allowances, reliefs and exemptions

There are a range of allowance reliefs and exemptions which can be applied to your estate that will significantly reduce your inheritance tax liability.

Below is brief a summary of those available. You should of course always take professional advice on the viability of these allowances in relation to your own individual circumstances.

The Nil Rate Band (NRB)

The NRB for each individual is £325,000. This means there is no inheritance tax to be paid on individual net estate valued at less or equal to £325,000. Currently, IHT at a rate of 40% is payable on the balance of the individual's estate above the NRB.

Any unused portion of NRB when a spouse or civil partner dies may be transferred to the surviving spouse or civil partner and used when calculating their liability for inheritance tax when they subsequently die. This effectively gives a total nil rate band per married couple of £650,000

The actual amount of NRB to be transferred is calculated by assessing the proportion (as a percentage) of the NRB that was unused at the time of the first death and applying the same proportion to the current NRB available at the time of the second death.

So, given that any transfer of assets between spouses or civil partners is exempt from IHT (see below), if a spouse or civil partner dies and leaves all of his or her estate to the surviving spouse or partner, the NRB threshold for the surviving spouse or civil partner would be double the then current individual NRB level.

For example, Mr and Mrs Smith are a married couple. Mr Smith dies and leaves his total estate to Mrs Smith. There is no liability for IHT and 100% of the NRB applicable to Mr Smith (£325,000) remains unused. When Mrs Smith dies some years later, the NRB in relation to Mr Smith is transferrable, so the NRB applicable to Mrs Smith's estate becomes £650,000.

As an alternative scenario, when Mr Smith dies he leaves assets equivalent to 50% of the NRB to their children and everything else to Mrs Smith. Therefore one half (50%) of his NRB is used leaving 50% available for transfer. When Mrs Smith dies the NRB threshold has risen to £350,000. 50% of the NRB in relation to Mr Smith is transferrable to Mrs Smith's Estate, so the NRB applicable to her estate becomes £487,500 (£350,000 + £175,000).

Key IHT allowances, reliefs and exemptions Continued

Gifting of assets and associated exemption

Gifts to certain beneficiaries are not subject to IHT. Others are subject to IHT but the rate of tax reduces to zero over a period of 7 years.

Gifts (or transfers of assets as they are termed) to the following beneficiaries are exempt from IHT:

- Spouse/ civil partner
- Registered charities
- Political parties
- Institutions for national purposes (for example the National Trust)

Additional IHT exemptions include:

Annual Exemptions

Individuals can give away up to £3,000 per tax year.

This exemption is backdated by one year in any given tax year so if the £3,000 limit is not used the balance can be used in the next year. (i.e. if the £3,000 is not used, a total of £6,000 may be given away in the next year).

Small Gift Exemptions

Gifts of up to £250 can be made to any number of individuals.

Normal Expenditure Exemption

Gifts that are considered to be made from income. These gifts must be made regularly (say annually or monthly) and must come from genuine income after tax (as opposed to capital). Good examples are birthday presents or the payment of insurance policy premiums. There is no upper limit on the amount which can qualify for this exemption.

Marriage or Civil Partnership Exemption

gifts made by certain individuals in the case of a wedding or civil partnership as follows:

- Parent – up to £5,000
- Grand Parent – up to £2,500
- Others – up to £1,000

Key IHT allowances, reliefs and exemptions Continued

Potentially Exempt Transfers

Usually the majority of gifts that do not fall into the above categories are considered Potentially Exempt Transfers commonly known to as PETs. The IHT rate applicable to these gifts depends upon the number of years that have passed between the date the gift was made and the date of death of the benefactor. The rate of tax to be paid is on a sliding scale reducing over 7 years which effectively reduces the rate of tax to zero. The rates of tax applicable are as follows:

Years between gift and death	Reduction in tax applicable
0-3	0%
3-4	20%
4-5	40%
5-6	60%
6-7	80%
7	100%

For example you make a gift of £100,000 and die 3 years 6 months after making the gift the IHT due will be discounted by 20% so instead of you estate being liable to inheritance tax at 40% i.e. £40,000, the liability would be reduced to £32,000 (£40,000 - 20% = £32,000). Please note that this only applies when the total value of gifts made in the previous 7 years exceeds the Nil Rate Band.

There are different classes of gifts which may affect you, particularly Chargeable Lifetime Transfers (CLTs) and Gifts with Reservation (GWRs). A gift with reservation such as transferring your house into your children's names but continuing to live in it will still be considered part of your estate for IHT unless you can demonstrate that a commercial transaction has taken place. These are something to be very wary of and we would recommend taking professional advice before entering to such an arrangement.

Simple ways to reduce inheritance tax

Among the many ways of reducing your liability, here are two simple straightforward ways of reducing your liability:

1 Discounted Gift Trusts and Gift and Loan Schemes

2 Gift and loan Trusts

Discounted Gift Trusts (DGT)

These are a method of reducing inheritance tax liability suitable for both single people and couples. They are sometimes referred to as Discounted Gift Plans or Bonds.

The potential advantages of investing in such trusts are that:

- The value of your estate for IHT purposes is reduced immediately.
- DGT reduce the value of your estate further if you survive 7 years after investing in the trust.
- DGT enables you to make withdrawals from the trust whilst ensuring that the funds are outside of your estate.
- DGT allow any remaining funds to be passed to your loved ones after your death.
- If the value of your investment grows, the growth in value will not form part of your estate for IHT purposes.

	No DGT	Death within 7 years of the DGT start	Death after 7 years of the DGT
Original investment	£100,000	£100,000	£100,000
Discount applicable	n/a	£66,530	n/a
PET value	n/a	£33,470	n/a
Amount potentially liable to IHT	£100,000	£33,470	£0
Maximum amount of IHT	£40,000	£13,388	£0

For example: Mr Smith invests £100,000 in a Discounted Gift Trust. Mr Smith is 60 years old and in good health. He chooses to withdraw £5000 per annum from the plan.

His investment immediately receives a discount of £66,530, which means this amount is not liable to inheritance tax. (the discount is calculated based upon the investor’s age, health and the amount of withdrawals to be made). The remaining £33,470 is treated as a Potentially Exempt Transfer (PET) and will be subject to Taper Relief. If Mr Smith survives 7 years it will be totally exempt from inheritance tax.

Simple ways to reduce inheritance tax Continued

Gift and Loan Trusts (GLT)

These are particularly suitable for individuals who want to retain access to their original capital but use the scheme as a vehicle to avoid paying increasing inheritance tax on the growth of their capital over time. With this type of scheme, all growth on the original capital remains outside of the individual's estate for the purposes of inheritance tax.

Loan schemes work in the following way:

a We establish a Discretionary Trust for you and you loan the trust an amount of capital.

b The trust invests the original capital to produce growth.

c Under the trust rules you set up the right to have the capital paid back to you partially or in full at anytime in the form of an interest free loan.

d You withdraw money from the trust in the form of a loan as and when required to supplement your income or for capital expenditure.

e Upon your death your estate must repay the loan in full, this considered a debt upon your estate and therefore reduces the value of your estate for IHT purposes.

Any amount of the original capital loan not repaid at the time of death (if you did not 'borrow' the full amount that you originally placed in the trust) will form part of your estate for IHT purposes, but any capital growth you have enjoyed will remain outside the estate.

Your home and inheritance tax

For the vast majority of us our houses are likely to be the most valuable asset we own. IHT relief above the Nil Rate Band will be available with the introduction of the 'main residence' band to be phased in gradually between 2017 and 2020.

- The new tax-free 'main residence' band will only be valid on a main residence where the recipient of the home is a direct descendant (children, step-children and grandchildren).
- This relief is being phased in gradually, starting at £100,000 from April 2017, rising by £25,000 each year until it reaches £175,000 in 2020.
- So in 2017 the maximum that can be passed on tax-free is £850,000 (£650,000 Nil Rate Band + £200,000 Main Residence Band) for married couples or those in a civil partnership, £425,000 for singles, (£325,000, Nil Rate Band plus the extra £100,000).

For couples, when the first one dies their allowance is passed to the survivor, so that £425,000 is doubled to £850,000.

- In 2020, the total IHT free amount will rise to £1m for couples, £500,000 for singles, as the main residence allowance rises.
- On properties worth £2 million or more, homeowners will lose £1 of the 'main residence' allowance for every £2 of value above £2m.
- This new relief will only apply to your main residence (so no benefit to those who decide to rent in later life).

Equity release

This is a method of releasing cash tied up in property, as many retired people are 'asset rich and cash poor' and this money can be used for anything you wish. However, early release of equity can be also used as a method of reducing potential IHT. The cash released could be gifted away and over 7 years (during which it would be subject to taper relief) it would be transferred out of your estate. In addition, the released cash could be used to set up a Discounted Gift Trust or Loan Scheme to reduce your IHT liability.

Wills and inheritance tax

A basic will makes provision for gifts and legacies, ensures your assets are distributed in line with your wishes and not subject to the laws of intestacy.

Many people believe that their assets will automatically pass to their chosen beneficiaries, but this is not necessarily the case and by making a will you are ensuring that you rather than the government decide how your assets are distributed.

In your will you can nominate your executors and guardians for your children if required. If you die without having a will in place you are deemed to have died 'intestate' which means that your assets will be distributed in line with a set of rules over which you have no control whatsoever.

In addition to the basic management and distribution of assets, the use of wills and trusts can be a very effective vehicle for avoiding or reducing liability for inheritance tax. It is particularly important if a couple are not Married but have shared assets, living in the same house for example, because the surviving spouse has no rights over assets that are not jointly owned.

Whatever your marital situation Discretionary Trusts can be established in line with your will so that on your death an amount equivalent to the Nil Rate Band is transferred into the Trust to reduce the taxable Estate of the surviving partner.

For example, Mr Jackson and Ms Jones, an unmarried couple not in a civil partnership, have drawn up their wills and have included in them clauses which state that on the death of the first party, an amount equal to the current Nil Rate Band (NRB) should be paid into a trust. This will not be liable for inheritance tax as it falls within the NRB. An additional clause also states that the surviving partner will not own the asset

but can take income or benefit from it so they can continue enjoy benefiting from the assets during their lifetime eg by living in the home.

When the surviving partner dies, they too will be able to leave assets up to the NRB threshold without an IHT liability, so both individuals will be able to use the maximum available NRB available. This method is not only effective for passing on cash and other tangible assets but can also be used for the passing on of property in a tax efficient and secure way.

Life assurance and inheritance tax

Life assurance policies can be used to help with inheritance tax (IHT) planning.

Policies are normally written in trust so that the sum assured is paid into the trust and does not form part of your Estate for inheritance tax purposes. Please note if you have any existing life assurance policies that are not written in trust the sum payable on your death will form part of your estate and will be liable for inheritance tax.

Using life assurance in trust ensures that your family has available capital to hand to pay the IHT which may arise in the event of your death without having to arrange a loan or use their own funds (Remember none of your assets can be sold to pay IHT. The tax must be paid to the Revenue before the assets from your estate are released to your beneficiaries).

Whole of Life policies

As I am sure you can ascertain a Whole of Life is just that; it provides life cover for the whole of your life even if you live to be 120 years old!

They can be taken out for an individual or as a joint plan to cover two people, typically a spouse or civil partners. A joint plan usually provides cover on a 'joint life second death' basis where no payment is made upon the death of the first person Insured but full payment is made upon the death of the second party – usually to pay off any IHT liability.

As the proceeds of this type of cover are normally designed to be used to pay off some or all of the final IHT liability, the level of cover is often set at an estimate of what your eventual IHT liability is likely to be. Payment would be made into a suitable trust on the second death so that it would not form part of the deceased's estate.

Whilst you do have the cost of paying the premiums this can be a more cost effective option than giving up access to capital or the future growth of that capital, or you may simply not be in a position to gift assets away at this time.

Term Assurance policies

A Term Assurance Policy can provide cover for a specific term, this is often seven years, for example, when you have gifted an asset to someone and the gift is regarded as a Potentially Exempt Transfer (PET) for IHT purposes. The policy would be written under trust to provide funds to your family to pay any outstanding IHT on such gifts (PETs), should you die during the 7 year period.

Long term care tax

Yes I know it isn't an inheritance tax but in my view it can be more pernicious amounting to a 100% tax on all of your assets above a nominal threshold should you have to go into residential long term care.

It seems grossly unfair to me that everything you have worked all your life for can be decimated in a few short years to fund your local authority care home.

100,000 homes are sold every year to fund long term care costs, and despite the promise of every government since John Major introduced it 1993 to address this evil tax no political party one has taken any action to stop people's family homes being sold.

By establishing a trust this can be avoided in the majority of cases. This trust helps to protects your property/ financial assets (up to the value of the nil rate band) from the local authority should you need to be admitted into residential care at some point in the future. Long term care charges can be

£30,000 a year so it doesn't take long to exhaust even the most wealthy and simple planning can avoid all the heartache and ensure there is something left to leave to your loved ones.

Conclusion

Inheritance tax is often described as a voluntary tax and one that can certainly be avoided. The best way to deal with the problem will depend upon you own particular circumstances and appropriate planning can only be arrived at by careful consideration of your own individual situation.

This can best be achieved by sitting down with a professional adviser and considering all of the options and then compiling a list of recommendations that will work best for you. Very often these do not have to be particularly complex or expensive.

I appreciate there is an awful lot to consider and the situation requires some very careful thought but I know from experience with clients there is a both a sense of relief and fulfillment when their asset protection strategies are put in place.

Unfortunately the scenarios we are considering are all rather grim but they are all scenarios that we will all after face at some point and I believe they will be easier to face with the peace of mind that all of our affairs are in order and that our loved ones are looked after as tax efficiently and effectively as possible.

I hope that you found our IHT guide useful and no doubt you will need to give all of the above some serious thought.

If you require further information please contact us on
0191 404 6806

If you'd to ask us any questions please get in touch with us:

0191 404 6806

service@pensionmatters.net

pensionmatters.net

The Axis Maingate Kingsway
Team Valley Gateshead NE11 0NQ

Pension Matters is a trading style of Estate Matters Financial Limited which is authorised and regulated by the Financial Conduct Authority. Registered in England and Wales No. 6334652. Registered address as above.