

Wills, Trusts and Probate Briefings

Inheritance tax planning

Careful planning can reduce or even eliminate the IHT payable. Inheritance tax planning is an important part of drawing up or reviewing your will.

Basic allowances and exemptions

IHT is not payable on the first part of the value of your estate - the 'nil-rate band'. For the tax year 2009/2010, the nil-rate band is £325,000. If the total value of your estate does not exceed the nil-rate band, no IHT is payable.

In addition, various gifts are exempt from IHT:

- Any assets you pass on to your spouse or registered civil partner are exempt from IHT. This exemption does not apply if you were merely living together (ie without marrying or registering a civil partnership).
- Gifts to registered charities are exempt from IHT. This exemption also covers various gifts to a number of similar organisations such as churches and public museums.
- Other gifts made during your lifetime, or assets put into trust, may also be exempt from IHT or reduce the amount of IHT payable (see below).

Since October 2007, the nil-rate band rules for married couples (or civil partners) have changed. If the first to die does not use up his or her entire nil-rate band, then the surviving partner will be entitled to a proportionate increase in the nil-rate band when she or he dies. For example, if a husband dies leaving everything to his wife, his entire estate is exempt from IHT. In this case, on the subsequent death of the wife, her estate would benefit from a doubling of the nil-rate band.

Lifetime gifts

Provided that you can afford to do so, giving away assets can be a very effective way of reducing the value of your estate - and so reducing any eventual IHT payable.

Although gifts made during the seven years prior to your death are included in your estate, there are several exemptions that allow you to immediately reduce the value of your estate:

- You have an annual exemption allowing you to give away up to £3,000. You can carry this exemption forward for one year if you do not use it.
- You can also make small gifts of up to £250 to as many individuals as you like. However, you cannot use both this exemption and the annual exemption to make gifts to the same individual.
- Special exemptions apply to gifts made to individuals getting married (or registering a civil partnership). You can give up to £5,000 to a child of yours, £2,500 to a grandchild, or £1,000 to anyone else.
- Any gifts to your spouse (or registered civil partner) are exempt.

Importantly, regular gifts out of income that do not affect your standard of living are exempt. This can be of significant value if you have a substantial income. For example, you might make regular contributions to a life insurance policy to help cover the IHT that you expect to be payable when you die.

Gifts of capital for the maintenance of dependant relatives (such as children, former spouses and disabled relatives) are also exempt.

Potentially exempt transfers (PETs) Lifetime gifts that are not covered by one of the exemptions are potentially exempt transfers (PETs). Provided that you survive for at least seven years, the gift will no longer be included within your estate and no IHT will be payable.

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If you die within seven years, IHT is calculated on a sliding scale:

- Less than three years, the full rate of IHT is charged at 40%
- For each additional year, the rate of IHT is reduced by one fifth. For example, if you die between four and five years after making the gift, IHT is reduced by two fifths and so charged at 24%.
- After seven years, no IHT is payable.

Gifts with reservation

In order to qualify as a gift, you must not continue to have any benefit from the assets you have given away. For example, if you give away your house - but continue to live in it, rent-free - the house will remain part of your estate and so liable to IHT when you die. Similarly, if you put assets in trust - but either are or could be a beneficiary of the trust - then they will remain within your estate.

In addition, if you give away assets but continue to benefit from them (eg keeping a valuable painting that you have 'given away') you may be liable to an income tax charge. This pre-owned assets tax (POAT) is based on the value of the benefit: for example, the rental value of a house or the market value of an asset such as a painting.

If you pay a market rent to occupy a property you have given away, then it does qualify as a potentially exempt transfer and you are not subject to the POAT. However, the income tax that the recipient will be liable to on your rental payments may well outweigh any IHT savings.

If you have entered into any arrangements such as this, you should take immediate advice.

Trusts

As part of your inheritance tax planning, you may want to consider putting assets in trust - either during your lifetime or under the terms of your will. Putting assets in trust - rather than making a direct gift to a beneficiary - can be a more flexible way of achieving your objectives. For example:

- You might want assets that will pass to a child to be held on trust until they are older.
- You might want assets to eventually pass to your children, but to ensure that your spouse can benefit from them for the rest of his or her life.

The tax treatment of trusts is complex, and depends on such factors as the kind of trust, the value of the assets put into it, and who the beneficiaries are. Recent changes to the rules mean that the tax treatment of many trusts is no longer as favourable as it used to be, but there are still circumstances in which they can help to reduce the overall level of tax payable.

You should take advice on whether trusts could be of benefit for your particular circumstances and requirements.

Business assets and other special cases Many forms of business assets qualify for substantial IHT reliefs. Investments in most unincorporated businesses (eg a partnership) and unquoted companies (including most AIM shares) qualify for 100% relief. Most assets used by a business that you controlled or were a partner in qualify for 50% relief.

Similar reliefs apply to agricultural property (such as farms) and woodlands.

To qualify, the assets must have been owned for two years prior to death. In addition, there are some restrictions: for example, investment and property businesses are generally excluded. There are also restrictions to prevent relief being claimed on 'farms' that are in reality being used as homes.

Death benefits from most pension schemes also fall outside the scope of IHT, though it is worth taking advice - particularly if you are planning to set up a new scheme as part of your IHT planning.

Special rules may apply to overseas assets, and where either you or a beneficiary (eg your spouse) is domiciled outside the UK. Again, advice should be taken to ensure that your planning takes into account any local laws overseas as well as relevant UK

legislation.

Practical issues

As well as considering opportunities to reduce IHT, effective IHT planning should take into account the practicalities of paying IHT and releasing assets to your chosen beneficiaries.

Assets cannot usually be sold or distributed until HM Revenue and Customs (HMRC) has received a full statement of your estate, and has been satisfied as to the payment of any IHT due. This may mean that the IHT due needs to be paid. (IHT can be paid in instalments over up to 10 years - plus interest - for some assets, in particular your house).

This has two important practical consequences:

- The executors named in your will need to understand their role. If your named executors do not include a professional to handle the paperwork, they may need to appoint one.
- The executors may need to raise cash to pay IHT. A life insurance policy that falls outside your estate can be a particularly effective way of providing for this.

Key planning principles

The complexity of IHT law provides substantial planning opportunities. Effective planning should take into account a number of key principles:

1. Focus first on your objectives - don't let reducing IHT overrule common sense, or your wish to take into account the financial needs of different family members and other potential beneficiaries.
2. Keep your planning as simple as possible. Bear in mind that tax law - or your personal circumstances - can change, and complex schemes may be difficult and expensive to unravel.
3. If you can afford it, look for opportunities to reduce the value of your estate - but don't give away more than you can afford to. Once assets have been given away, they may be gone forever. For example, your children may decide that they do not want to support you in your old age, or themselves lose control of assets in a divorce.
4. Early planning offers the greatest opportunities. The sooner you can give away assets, the more likely you will survive the gift by at least seven years.
5. Even late planning is better than nothing - for example, ensuring that you have used up your annual gift allowances.
6. Don't take risks you cannot afford. For example, investing in AIM shares might be a useful way of reducing likely IHT - but could also expose you to the risk of substantial falls in the value of the shares. A mix of different strategies may be an effective way of protecting against such risks.
7. Ensure that you take into account the full tax picture. For example, disposing of assets during your lifetime may give rise to a Capital Gains Tax (CGT) charge that offsets or even outweighs any likely IHT saving.
8. Consider the long-term view. Assets that your beneficiaries will receive may in turn form part of their estates when they die - and be liable to IHT then. Skipping a generation (ie giving gifts to your grandchildren rather than your children) may be an option for overcoming this.

A professional advisor who fully understands your objectives and personal circumstances can help you develop an IHT plan tailored to your particular needs.

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