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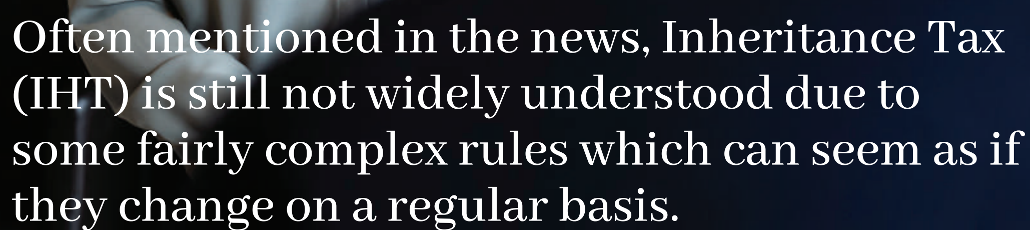
YOUR LOCAL INDEPENDENT FINANCIAL ADVISER

Inheritance Tax – a guide to keeping wealth within your family



Often mentioned in the news, Inheritance Tax (IHT) is still not widely understood due to some fairly complex rules which can seem as if they change on a regular basis.

[1] HM Treasury Budget, October 2018.

This is concerning as it is something that affects thousands of people every year. Frequently thought of as only being an issue for the extremely wealthy, many are surprised to learn that with rising property prices, more families than ever are facing an Inheritance Tax bill.

In fact, the amount of IHT collected is expected to reach £6.9 billion by 2023-24, an increase of £1.5 billion in just five years.[1]

If your estate has an Inheritance Tax liability, your beneficiaries will have to pay the Inheritance Tax bill. This is obviously not the kind of legacy many people would like to leave behind.

Fortunately, there are lots of ways you can be proactive to combat potential IHT problems. However, finding the right solution for your set of personal circumstances can be complicated and a daunting task to take on yourself. Talking to an independent financial adviser about your situation can make a real difference.

In this guide, we set out some of the options available.

Inheritance Tax as we know it dates back to 1894, when the government introduced 'estate duty' as a tax on the capital value of land.

Fundamentals

Inheritance Tax must be paid on the value of your assets - any money and possessions you leave behind when you die and also possibly on some gifts you made during your lifetime.

When you die, your 'estate' comprises the assets you leave behind.

Your estate can include:

- Any properties you own
- Any savings or investments (some pensions are excluded from your estate, but other investments, including most ISAs are taxable)
- The value of any life insurance policies in your name
- Any other assets.

You can leave your entire estate to your spouse or civil partner without incurring IHT.

However, if you choose to leave some or all of your estate to family and/or friends, it may be liable for IHT.

How to work out what your estate is worth

After adding up all your assets, the next step would be to subtract any outstanding debts. This includes any credit cards, loans and mortgages you may have. It is also possible to deduct the value of some gifts you make during your lifetime (we'll explain more later), charity donations you may have left in your will and the reasonable costs of your funeral.

When you have calculated the value of your estate for IHT and:

1. The value of your estate less than £325,000...

Your estate won't face an Inheritance Tax bill at the moment. However, you should monitor the value of your assets because any changes between now and when you die could result in IHT liability for some assets you leave behind as part of your estate.

2. Your estate worth more than £325,000...

Your 'nil-rate band' will be fully used up, and the remainder of your estate will be liable for IHT.

An example:

Robert's estate has a value of £500,000 and the tax-free threshold is £325,000. The Inheritance Tax charged will be 40% of £175,000 (£500,000 minus £325,000). The Inheritance Tax payable will be £70,000.

How marital status affects Inheritance Tax

Whether you are single, married or in a civil partnership will change how the IHT rules apply.

Single
If you are single and your estate is worth more than £325,000, anything over that subject to IHT at 40%.

Married or Civil Partnership
Those that are married or in a civil partnership are able to leave assets to your spouse/civil partner without incurring IHT. Leaving assets to a spouse does not use up your nil-rate band.

If you pass on any of your estate to someone other than your spouse/civil partner and your estate is valued in excess of £325,000, then the additional value will be subject to up to 40% IHT.

The estate of your surviving spouse/civil partner will be subject to IHT as per the below:

Widowed
When a person dies, their unused nil-rate band can be transferred to their spouse or civil partner.

So, if your spouse left everything to you, you could have a combined nil-rate band of £650,000 applied to the value of your estate.

Unmarried couple
If you are part of an unmarried couple, you will be considered single for IHT purposes.

This means that each of you has a separate nil-rate band of £325,000 which cannot be combined if one person dies.

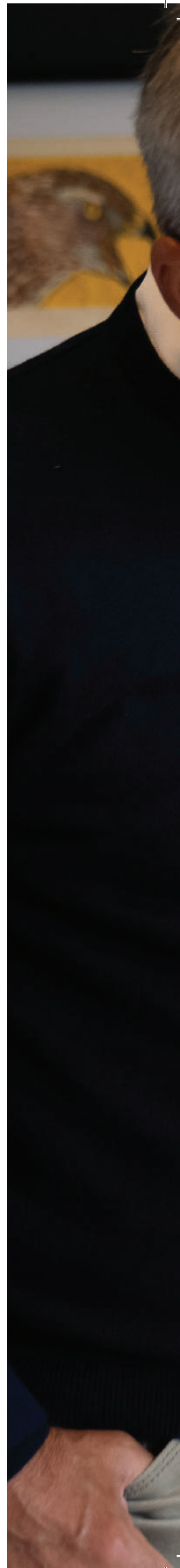
In practice, this is what a combined nil-rate band looks like:

Robert dies, leaving his entire estate (£500,000) to his wife Jill

Jill now has combined assets (£500,000 + £450,000 of her own) of £950,000

Subtracting the combined nil-rate band (£950,000 - £650,000) leaves £300,000 which is Jill's taxable estate

Jill's estate would be taxed at 40% so the Inheritance Tax bill (£300,000 x 40%) would be £120,000.



The residence nil-rate band

After years of rising house prices IHT is a problem for homeowners. Due to increasing property valuations, more people are now facing an IHT liability on their estate. Additionally, the current nil-rate band of £325,000 for inheritance tax is expected to remain frozen until 2021.

The Government acknowledged the IHT problem faced by many homeowners in 2015 when an additional Inheritance Tax allowance of up to £175,000 was introduced to apply to the family home in certain circumstances:

- You must be planning to leave a home to a direct descendant.
- The residence nil-rate band applies to the estates of people who die after 6th April 2017.
- The nil-rate band will increase in line with inflation every year from April 2021.
- The allowance was phased in and reached the maximum of £175,000 per person (£350,000 per couple) for deaths that occur after 6th April 2020.
- Adding this to a couple's nil-rate band equals £1 million per couple.

Despite the intentions of the residence nil-rate band, the number of people who will be able to leave an estate worth £1 million completely free of inheritance tax is likely to be limited.

Who can claim the new allowance?

The intention is that married couples and civil partners can pass on assets worth £1 million, including the family home, without paying any inheritance tax at all.

However, not everyone will benefit, and there are a few rules to be aware of:

- This allowance will apply where the person who has died owned a property that was at one time their home.
- Only one property will qualify, even if multiple properties are owned and have been lived in.
- It will only be applicable if the property is left to the direct descendants of the deceased.
- The allowance won't assist you if you don't own a property.
- It won't benefit anyone without direct descendants, or anyone leaving their home to someone other than a direct descendant.
- People owning a property worth less than £175,000 per person (£350,000 per couple) will not benefit from the allowance in its entirety.
- Much larger estates may not benefit as the residence nil-rate band will be reduced by £1 for every £2 by which the estate exceeds £2 million.
- The allowance is not available to anyone who disposed of their property for any reason before 8th July 2015. This includes because they have moved in with family or to a residential care setting.

Gifts can reduce your IHT liability

There is usually no IHT to pay on small gifts you give, such as Christmas or birthday presents. You can make small gifts of up to £250 to as many different people as you like. These are known as 'exempted gifts'.

You are also not liable to pay IHT on gifts between spouses or civil partners. You can give them as much as you like during your lifetime, as long as they live in the UK permanently.

A gift can be:

- Anything that has a value, such as money, property, possessions.
- A loss in value when something's transferred, for example if you sell your house to your child for less than it's worth, the difference in value counts as a gift.

You also have a gifting allowance of £3,000 every year called the 'annual exemption'. If the full £3,000 annual exemption isn't used in one year, you can 'carry over' the remainder to the following year. It is only possible to use this remainder for one year.

In addition, each tax year you can also give away:

- Wedding or civil ceremony gifts of up to £1,000 per person (up to £2,500 for a grandchild or great-grandchild, up to £5,000 for a child).
- Normal gifts out of your income (up to £250 at a time), for example Christmas or birthday presents. However, you must be able to maintain your standard of living after making the gift(s).
- Payments to help with someone else's living costs, such as an elderly relative or a child under 18
- Gifts to charities, national museums, universities, the National Trust, political parties and some other organisations such as housing associations.

You can use more than one of these exemptions on the same person - for example, you could give your grandchild gifts for her birthday and wedding in the same tax year.

You can give as many gifts of up to £250 per person as you want during the tax year as long as you have not used another exemption on the same person.

Charitable Legacy

If you leave part or all of your estate to charity, it can reduce or sometimes even eliminate your IHT liability. Whatever you leave to charity in your will won't count towards the total taxable value of your estate.

Leaving at least 10% of your 'net estate' to charity results in cutting the Inheritance Tax rate on the rest of your estate from 40% to 36%.

Although donating the money to a charity means you would be leaving less for your beneficiaries, it does mean there will be less IHT to pay. It's an option worth considering if you are already a keen supporter of a charity or would like to leave a charitable legacy anyway.

The rules regarding what you can give away to charity to secure the lower tax rate aren't always straightforward so it really is best to consult someone that can assist you with estate planning to be sure you will achieve what you want.

Setting up a Trust

Trusts are usually set up to make sure wealth stays within the family over generations. Trusts can be a very efficient way to reduce your IHT liability and the biggest advantage is the flexibility they can offer. They can be set up exactly how you want them to be, leaving no room for assumptions.

The 7 Year Rule (page 12) still applies to money gifted via a Trust.

Discretionary Trust

These are usually set up to provide money for a group of beneficiaries – for example, children or grandchildren – but responsibility for managing the assets in the trust is given to someone else, known as the trustee.

For IHT purposes, assets in a discretionary trust are outside of the estate, provided the person who set up the trust lives more than 7 years. However, IHT can be payable:

- at the outset
- every ten years (known as 'periodic' charges)
- when trust assets are paid out to beneficiaries if death occurs within 7 years of setting up.

Discounted Gift Trusts

This is when a person makes a gift to a trust while retaining the right to pre-agreed payments of capital from the trust during their lifetime. For IHT purposes, the gift is valued after applying a 'discount' based on the person's age, sex and health.

This means the person can immediately reduce the value of their taxable estate by the amount of the 'discount' applied to their

gift to the trust, while retaining the benefit of the regular payments from the trust during their lifetime.

The discount is given because the trust will be paying amounts out to the owner for the rest of their life. But if these amounts are not spent, they will again be subject to IHT when the owner dies.

A disadvantage of discounted gift trusts is that the payment amount cannot be amended so they are less flexible than discretionary trust

Immediate Post Death Interest Trusts

These ensure that one beneficiary receives a ‘life interest’ in the assets in the trust. A life interest could be something like the right to live in a property, or the right to receive rent from a property for the rest of their life.

The capital held in the trust has to be passed to different beneficiaries in the future.

For example, a person that has children from a previous marriage but has since remarried can arrange for a trust to be set up in their will for their current spouse, naming them as the ‘lifetime beneficiary’ or ‘life tenant’. The spouse will receive an income from that trust for the rest of their life. On the death of the initial beneficiary, the capital in the trust will pass to the children from the person’s first marriage.

The assets in the trust, not just any unspent income from it, are classed as part of the lifetime beneficiary’s estate for IHT purposes. When they die, the value of the trust is part of their ‘death estate’ and so may utilise some or all of their nil-rate band and IHT may be payable.

Loan trusts

Usually when a person sets up a loan trust naming themselves as the trustee, it is to benefit someone else. The trustee makes a loan to the trust which is often invested in an investment bond with the potential for growth. The original loan is repayable, usually in regular instalments.

The benefit of doing this is that although the original amount in the loan remains part of the estate, any growth from the bond is outside of the estate and so is exempt from IHT.

Using Life Insurance to cover IHT

Taking out life insurance to cover all or part of your IHT liability is an option and can make the process easier for your family when the time comes. You may also be able to avoid selling any property to pay the bill which usually has to be paid before probate is granted.

Most life insurance policies will count as part of your estate unless the policy is written 'in trust', meaning when a claim is made, the money is paid out to beneficiaries and not the estate, making it exempt from IHT.

If you are considering taking out life insurance to pay your IHT bill, there are two types of cover available:

Whole of Life: With this policy, you specify the amount of cover you want and then pay premiums to secure this. The cover continues for as long as you pay the premiums, until you die. The amount agreed is then paid out to beneficiaries as defined by the trust if one was set up.

The beneficiaries can then use the lump sum to pay all or some of the Inheritance Tax.

Term Insurance: Also known as 'decreasing term' or 'level term' policies. If assets have been given away to people other than your spouse or civil partner and you die within 7 years, anyone on the receiving end of the gift could end up with an IHT bill.

A type of policy called 'Inter Vivos' is a decreasing term insurance policy which can provide a lump sum pay out on death matching any IHT liability on a Potentially Exempt Transfers (see 7 Year Rule) over the nil-rate band for Inheritance Tax.

These policies last a certain amount of time, and only pay out if you die within the stated period. After this time, the policy expires.

Taking out insurance doesn't reduce the amount of IHT due, but it is useful to consider as another way to pay a potential IHT bill.

The 7 Year Rule

Some gifts may be subject to IHT and these are usually called 'Potentially Exempt Transfers' (PET).

The gifts become IHT free if the person making the gift survives for seven years after the gift is given. If death occurs within seven years, the value of the gift must be included in their estate. The person who received the gift will have to pay any IHT owed.

Taper Relief

Interestingly, the gift isn't automatically liable for 40% tax. If the person making the gift survives between three and seven years after the event, the rate of IHT due reduces, known as 'taper relief'.

The nil-rate band is applied against gifts made in the last seven years first. So, taper relief only helps where gifts worth more than £325,000 have been given away in the seven years before death.

Years between gift made and death	Rate of taper relief
0 – 3	No relief – 40% tax
3 – 4	32%
4 – 5	24%
5 – 6	16%
6 – 7	8%
7 or more	No IHT due

An example:

Jane died on 1 July 2018 and she was single.

Jane left 3 gifts in the 7 years before her death:

£300,000 to her brother 6.5 years before her death

£50,000 to her sister 4.5 years before her death

£150,000 to her friend 3.5 years before her death

Jane is not entitled to any other gift exemptions or reliefs.

The IHT threshold is £325,000 and anything below this amount is tax free.

£300,000 of the allowance is used up by the gift Jane gave her brother. There is no tax to pay on his gift.

The remaining £25,000 is used up by her £50,000 gift to her sister. There is tax to pay on the amount not covered by the threshold. That means there's tax to pay on £25,000 of the gift to Sally's sister at a rate of 24% (see table opposite)

The £150,000 gift given to her friend is taxed at a rate of 32%.

Jane's remaining estate was valued at £500,000 and charged at the usual 40% inheritance tax rate.

Jane used up the tax-free threshold on gifts given before her death.

Types of Gift

When an individual makes a gift that is not exempt from IHT, there is a transfer of value that is measured by the loss to the donor's estate immediately after the transfer is completed. A transfer of value could be either a Potentially Exempt Transfer as mentioned above or an immediately chargeable transfer (known as a Chargeable Lifetime Transfer).

CLTs are gifts made by an individual but because they do not immediately pass to another individual or certain types of trust, are immediately assessable for IHT as well as on death within 7 years.

How the order of gifting can affect what IHT is payable on death
If a CLT was made followed by a PET, the personal representatives may have to look back 14 years prior to the death of the donor to account for any chargeable gifts.

To calculate the tax on a chargeable transfer, it is necessary to total this with any other chargeable transfers made in the immediately preceding seven years to the gift in question. This means when a PET fails and becomes a chargeable transfer, any other chargeable transfers made within the previous 7 years must be taken in to account. Because of this, a CLT made nearly 14 years before the donor died is still within cumulation.

An example:

- Arthur died on 1st January 2018 having made the following gifts:
- On 3rd January 2004 Arthur made a CLT establishing a discretionary trust with £200,000
- On 2nd January 2011 Arthur made a PET gifting a property with a value of £350,000 to his adult grandson

The IHT would be payable as follows:

- There are less than 7 years between the two gifts and less than 7 years between Arthur's death and the PET. Therefore the PET becomes a CLT.
- The CLT reduces the nil-rate band (NRB) that can be used against the PET as it was made within 7 years of the PET
- The NRB is assumed to be £325,000 and as death occurred more than 6 years after the PET, the IHT rate becomes 8% after taper relief (see above).
- The NRB of £325,000 is reduced by the CLT of £200,000 to £125,000
- The failed PET £325,000 less NRB £125,000 = £225,000 x 8% = £18,000:
- The IHT of £18,000 is payable by Arthur's grandson as the recipient of the gift.
- All of Arthur's NRB has been used up by the cumulative chargeable transfers, leaving none remaining against his estate.

Keeping records
You're under no obligation to record the details of gifts made during your lifetime. However, it can be extremely helpful if you do. The executors who deal with your estate will have to account for any gifts you made during the last **fourteen** years of your lifetime. Keeping records will make this process much quicker.

Can my family inherit my pension?

Pensions are normally IHT free, unlike many other investments. They do not form part of your taxable estate. What can and cannot be inherited depends on the type of pension you hold.

Defined Contribution
When you die, any unspent money in your pension pot can be passed on to one or more beneficiaries of your choice. This assumes you have a defined contribution (rather than defined benefit) money purchase pension scheme, which is the case for most workplace pensions and all private pensions.

This is only applicable if you have unspent pension remaining and may not be the case if you have already bought an annuity. An annuity is an insurance product. A lump sum is paid to a provider and they agree to pay you a regular income for the remainder of your life.

Therefore, when your life ends, so does the agreement. It is not something you are able to pass on. However, if you chose to take out a 'joint-life annuity' then your partner would continue to receive the income. You also are not obliged to spend your entire pension pot on an annuity (up to 25% of your pot can be taken tax-free) so the unspent portion would still be inheritable.

In 2014, a decision was made to allow people with defined contribution pension pots to 'draw down' on their lump-sum pension, and use it to provide an income instead of purchasing an annuity. This pot is likely to be able to be left to beneficiaries if it hasn't been drawn completely when death occurs.

Defined Benefit
If you have a defined benefit pension, otherwise known as a final salary pension, there is no pension pot to pass on. However, the terms of these schemes can vary and your particular scheme may have made a provision for your spouse and/or your dependents.

Personal Pension
If you have a personal pension, such as a SIPP or a stakeholder pension, this can be passed on to your beneficiaries just as a workplace (defined contribution) pension can be.

Will my pension be subject to IHT?
When you leave a pension pot (defined contribution or personal pension as above), the age at which you die affects any tax payable.

If you die before turning 75

Anyone who inherits your pension will not be required to pay income tax as they draw it down.

If you die after turning 75

The amount of income tax to be paid by the beneficiary will be determined by the income tax status of whoever inherits the pension. They will be required to pay income tax at their standard rate whenever they draw amounts out (the rates of tax are 20%, 40% and 45%).

You will be subject to income tax on pension income you receive in your lifetime, and if you haven't spent it, the amounts drawn down will form part of your taxable estate when you die and be subject to Inheritance Tax.

The current rules relating to pensions are complicated. If you're unsure of how they apply to you, please talk to us or any independent financial adviser before making any decisions.

Make a Will

Your will forms the basis of your Inheritance Tax Plan. Make sure you have an up to date will that is located somewhere safe that your executors know about. It should be reviewed regularly and after big ‘life events’.

If you die without leaving behind a will, the legal term is that you have died ‘intestate’.

Without a will, you have no say in what happens to your assets and possessions in the event of your death. It is possible to write a will yourself, but it makes sense to get legal advice to make sure that the will is legally binding and that your wishes will be followed correctly.

When thinking about creating your will, you might want to obtain professional advice. Solicitors, tax advisers and financial advisers can assist you with this.

Please don’t hesitate to ask us if you need some help, it is one of the ways we would be happy to assist with your holistic financial planning.

Keep your wealth within your family

We could help you to save thousands of pounds for the people you care about.

Inheritance Tax rules can be complicated and change often. We hope this guide goes some way to explaining the many options available but nothing compares to truly independent advice. Our independent financial advisers deal with IHT issues on a daily basis and can take the guess work out of it for you.

We can check that you are using your allowances efficiently and whether there are sensible ways to reduce any liability you may be facing. Our aim will be to help you keep wealth within your family, exactly what we would wish for our own families.

Give us a call today to see if we can save your loved ones money to help secure their future.

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This guide is intended for UK residents and all figures and examples are correct at the time of publication (November 2020). The explanation of all of the tax rules in this guide have been written in accordance with our understanding of the law and its implementation at the time of publication. The content within does not constitute financial advice and is provided for general information purposes only. Harold Stephens Ltd is authorised and regulated by the Financial Conduct Authority and entered on the Financial Services Register under reference 592993.