



Time To Think About Inheritance Tax

What Is Inheritance Tax?



Inheritance Tax (IHT) is, essentially, a tax levied on any transfer of assets to other people or trusts. It is most commonly paid in respect of an individual's estate on death, but it can also apply in respect of certain transfers of assets during life. Under current legislation, IHT is often perceived as a voluntary tax. This is because with careful planning, it is possible to reduce or remove any liability.

The Tax Liability

It is a mistaken assumption that you need to be particularly wealthy to incur a substantial IHT liability. When you die, the value of your taxable estate is calculated as the total value of all of your worldwide possessions and assets, less any available exemptions and reliefs. If the taxable estate exceeds the nil rate tax band of £325,000 anything over that sum is taxed at 40%.

Although this level is reviewed regularly, it has historically not kept pace with the increase in asset values, particularly property prices.

From 2007 any unused "nil rate band" maybe transferred between spouses or civil partners on the death of the first spouse/partner, effectively doubling the nil rate band for the surviving spouse/partner to £650,000.

There is only one tax band with inheritance tax. Everyone is a higher rate taxpayer.

Exemptions and Reliefs

Certain gifts are not liable to IHT because of specific exemptions or reliefs, as described in the following sections.

Spouse exemption

Transfers between spouses, whether during life or on death, are generally exempt from IHT. Spouses are married couples who live together. Since 2005 this exemption also applies to civil partners.

Annual exemption

Lifetime transfers by individuals of up to £3,000 per tax year are exempt from IHT. If the whole of the £3,000 is not used in any tax year, the balance can be carried forward to the next tax year, but not beyond that.

Small gifts exemption

Outright gifts of up to £250 to any number of people in any one tax year are exempt from IHT.

Normal expenditure out of income

Gifts which can be shown to be paid out of normal income are exempt from IHT.

To obtain exemption from IHT, the gift must be part of your normal expenditure. The HM Revenue & Customs take the view that a

series of three gifts will establish this as "normal expenditure". The gifts must not, taking one-year with another, reduce your available net income below that required to maintain your usual standard of living. You cannot give up your income and live on your capital.

The exemption will often apply to insurance or investment policy premiums paid for the benefit of someone else and held in trust.

Gifts in consideration of marriage

Gifts of up to £5,000 by a parent, £2,500 by a grandparent, £2,500 by one party to the marriage to the other, or £1,000 by anyone else, are exempt from IHT.

Since 2005 such gifts also apply to civil partnerships.

Business Property Relief

Business property relief is available on transfers of "business property", providing certain conditions such as the length of ownership and type of business are satisfied



Agricultural Property Relief

Agricultural property relief is available, in respect of the agricultural value, on the transfer of agricultural property, providing certain conditions as to the length of ownership are satisfied. The relief can currently be 50% or 100% depending on the particular circumstances.

Potentially Exempt Transfers (PETs)

This is a term which describes most lifetime gifts and which, subject to certain conditions, will not incur a liability to IHT. Specifically, gifts between individuals are termed PETs. A PET made at least seven years before death becomes an exempt transfer and will not be chargeable to IHT. Payments into trust used to be considered as PETs but budget changes implemented in 2006 meant that such payments are now potentially chargeable to immediate payment of tax at 20% if the gift, when added to

previous accumulated chargeable gifts in the previous 7 years, exceeds the current nil rate band.

This charge does not however apply to gifts into certain trusts known as BARE TRUSTS



Use of trusts



There are a number of trusts which can be used for IHT planning. Their suitability depends on the precise requirements of the individual.

Some of the reasons for establishing a lifetime trust include:

- the ability to make a gift of assets while maintaining control,
- providing for minor children who are too young to take legal responsibility for gifted assets,
- to avoid or reduce IHT, Capital Gains Tax and Income Tax,
- providing a flexible environment for the future.

Discretionary Trusts

Discretionary trusts can be a useful tool for IHT planning, as they remove assets from the chargeable estate of the settlor (the person setting up the trust). A gift into a discretionary trust is referred to as a Chargeable Lifetime Transfer. This means that a lifetime gift into a discretionary trust is subject to an immediate charge to IHT. Following the budget changes implemented in 2006 most trusts will now be taxed upon the basis of the existing discretionary trust taxation legislation.

However, a gift within the nil rate band (currently £325,000) would not incur a charge to IHT. An individual could remove from his chargeable estate every seven years an amount equivalent to the nil rate band, by gift to a discretionary trust, with no charge to IHT.

The settlor of a discretionary trust can also be a trustee of the trust. Therefore control of the assets can be maintained. They should not however be a beneficiary.

Discretionary trusts are also useful for assets with high growth potential, as the increase in the value of the asset can be removed from the estate so that the potential saving in IHT may be higher than originally envisaged.

Trusts established under the discretionary trust tax legislation are subject to the possibility of a 10 year tax charge at a maximum level of 6% and possibly an exit charge – however, the real overall tax rate is often considerably less and certainly more favourable than 40% IHT suffered if the assets still formed part of your estate.



Other Relevant Points

Joint Ownership

Where property is in joint ownership, it will either be held under a joint tenancy or as tenants-in-common. The type of tenancy has an important implication for IHT planning.

In the case of a joint tenancy, when a co-owner dies, his or her interest passes automatically (irrespective of any Will he or she may leave) to the surviving co-owner. Whereas in the case of tenants-in-common, the share of a joint owner passes on death in accordance with the deceased's Will or the laws of intestacy.

Interaction with Capital Gains Tax

Capital Gains Tax (CGT) is not payable on death. All assets are automatically uplifted to their market value. Therefore, it may be advisable to retain an asset until death and incur an IHT liability, rather than incur a higher CGT liability by disposing of the asset in an IHT planning exercise.

Reservation of Benefit

Any attempt by an individual making a gift as part of an IHT planning exercise to reserve a benefit, is likely to invalidate the original gift. An example would be a gift of shares, while retaining the right to dividend income.

Where the person making the gift reserves a benefit for himself, then the value of the property in question at the date of death will be included in the deceased's estate for IHT purposes.

Pre-owned asset tax (POAT)

Strictly this is not inheritance tax but a new tax based upon assets transferred but from which you enjoy benefit. POAT is not, in the Revenue's eyes, retrospective in that it is an ongoing tax but assets owned and transferred since 1987 are looked at to establish any ongoing liability.

Valid and up to date will

An essential part of any IHT planning exercise is a valid and up-to-date Will.



Financial Products

Protection of the estate on death

This is generally the province of life assurance policies. This is a well established, and arguably, the most effective method of meeting an IHT liability. As the date of death is uncertain, a whole life policy is effected to ensure that capital is available at death to meet the IHT bill. Policies are normally written under a suitable trust arrangement to ensure that the policy proceeds do not form part of the deceased's estate on death.

All life assurance policies should normally be written in trust from inception, to prevent the proceeds forming part of the donor's estate and themselves being liable to IHT.



Inheritance tax mitigation schemes

There are many schemes available to reduce a potential IHT liability, here are a few of the most regularly used:

Flexible Loan Trusts

These are designed to couple IHT savings with full access to capital. The investor invests in a capital investment bond for say £1,000, written in trust for prospective beneficiaries. He then makes a significant loan to the trustees, on an interest free basis, repayable on demand. The trustees invest the loan in a separate bond, then take annual withdrawals and pay these to the investor in repayment of the loan. These will be typically set at 5% pa, repayable on demand. Any growth on the investment is instantly outside the investors estate for IHT purposes.

Discounted Gift Plans

This is best described by way of example:

Client (aged 79) requires income, but wishes to pass on her savings to her family as tax efficiently as possible. She invests £250,000 in this type of plan and takes a level income of £12,500pa, 5% of the original investment each year.

If she dies within 7 years HM Revenue & Customs will give a potential reduction of £133,000 in the value of the estate for IHT purposes (the discount). If she survives 7 years, the whole of the original £250,000 plus any subsequent growth will fall outside her estate. An income of £12,500 per annum will be payable as long as she lives or the investment funds allow.

“Conveyor belt” schemes

These plans allow investors the opportunity to mitigate inheritance tax via the use of a Chargeable Lifetime Transfer and yet retain “income” from their fund during their lifetime.

The major benefit of these schemes is that although the investment is removed from your taxable estate over a 7 year period, you will still have the option to take, if required, a ‘reversion’ of a portion of your funds each year. However, a key point to bear in mind is that you will lose the right to receive all of your capital back personally as a lump sum.

In the trust deed you specify the division of your investment into a series of parcels of units. At outset the arrangement consists of a series of parcels of units with consecutive annual reversion dates - say twenty parcels of 5% with the first parcel maturing in one year, the second in two years and so on. The arrangement mimics a conveyor belt loaded with twenty parcels of units, each parcel due to fall off the end at one-year intervals.

Pensions

It is possible to invest up to £3,600pa gross into a personal pension for children or grandchildren. Own personal pensions should be written in trust. See spousal bypass trusts below. Generally, by saving into a pension plan you are building up IHT free funds.

Spousal Bypass Trust

Most people complete a nomination form for their pension benefits to cater for death in service benefits. The majority will nominate in favour of their spouse/partner. It is possible to nominate a discretionary trust to ensure the benefits never form part of the widow(ers) estate, but (s)he still has access to the trust’s assets.

AIM Portfolios & Residential Property Development Companies

This investment opportunity will help all investors either to defer or mitigate potential IHT liabilities for their beneficiaries.

All investors will benefit from Business Property Relief (currently at the rate of 100%) after 2 years trading in the AIM market or residential property development. The investment structure enables investors to retain complete control over the operation of their own individual company.

Each investor will be the sole shareholder of their own newly created private limited company and will undertake a number of residential property development activities in partnership with other similar companies under the guidance of a merchant bank or have a portfolio of AIM shares arranged on their behalf. This scheme can be set up with the minimum of fuss and paperwork.

Equity Release Schemes

These popular schemes involve you releasing capital from your home. Put simply, you arrange an interest only loan on your property, the capital and interest roll up until the death of the borrower (the second death in the case of a married couple). This loan will be a debt on the estate and that is chargeable to IHT. Effectively reducing the estate by the amount of the loan.

The released capital could be reinvested into an IHT efficient plan such as a Discounted Gift Plan.



What do I do now?



IHT can be a complicated area, but with careful planning and expert advice the worries and complications can be taken away from you. It is important to seek independent expert advice. The next step should be to arrange a meeting to discuss your particular circumstances, needs and objectives, and develop a tailored IHT plan which will minimise any IHT liability.



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