BASIC INHERITANCE TAX PLANNING

Whilst we, Swallow Financial Planning, try to keep abreast of the principles of various tax planning issues you ***must*** seek specialist advice before taking any action. We utilise specialist lawyers for inheritance tax (IHT) planning and planning relating to the use of the marital home within estate preservation arrangements. Dealing with capital gains tax (CGT) on anything other than the simplest scheme requires the services of an expert accountant. Professional fees are always expensive and should be taken into account when considering any of the ideas we put forward within this document.

SECTION **PAGE**

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1. GLOSSARY OF TERMS

The following are some commonly used IHT planning acronyms:

BMTs	The Bereaved Minor's Trust
CGT	Capital Gains Tax
DGS	Discounted Gift Scheme
DT	Relevant Property Or Discretionary Trust
GOOI	Gift Out Of Income
GAAR	General Anti Abuse Regulation
GWR	Gift With Reservation
HMRC	Her Majesty's Revenue And Customs
IHT	Inheritance Tax
IIP	Income In Possession Trust
IPDI	Immediate Post Death Income In Possession Trust
IT	Income Tax
NRB	Nil Rate Band
NRBDT	Nile Rate Band Discretionary Trust
PET	Potentially Exempt Transfer
POAT	Pre Owned Asset Tax
PPRR	Principal Private Residence Relief

Within this document, reference to males includes females and reference to marriage includes civil partnerships.

2. FINANCIAL ASSESSMENT

We are particularly well equipped to advise clients and their legal/taxation advisers alike as to the extent of the liabilities. We should have a full list of a client's financial affairs, an assessment of their business values and we should know what, if any, insurances and pensions are already written into trust. This is the essential first step to any advice and is avoided at one's peril!

2.1 Jointly Held Assets

Many clients do not appreciate that jointly held assets (typically your main home) do not pass via your Will but instead automatically pass to the joint tenant on your death. Therefore, if you wish to include, say, your share of the property in your Will you need to break the joint tenancy in favour of tenants in common.

3. WILLS

We will need to review your Will before we provide any specific advice. The Will is one of the most effective tax planning tools available for most couples. Please see our notes on Wills for further information.

4. HOW MUCH TAX WILL YOU HAVE TO PAY?

Inheritance tax (IHT) is charged on estates worth over £325,000 (2018/19). For those who are single the first £325,000 is tax exempt, but everything beyond £325,000 is subject to tax at 40%.

There is no tax to pay on gifts between husband and wife so if no gifts are made when the first spouse dies a married couple can leave up to £650,000 before tax is due.

In 2016 the Residential Nil Rate Band (RNRB) came into effect. This is a "dogs breakfast" piece of legislation which makes claiming the benefits uncertain. See our separate notes on the RNRB however for these purposes the RNRB can increase a couple's IHT threshold to a maximum of £1 million (post 2022) where the family home is being left to children.

Remember that the value of your estate includes your home, your pension funds, your life assurance and any absolute benefits you may have within trust funds. This will for a large element of the population, place them well into a 40% tax liability.

5. USING WILLS TO REDUCE IHT

The changes to trusts and the introduction of the transferrable nil rate band between married spouses has led to a new regime for Will planning.

The carry forward provisions allow for any remaining allowances from previous spouses to be carried forward to the last to die subject to a maximum carry forward of 200% of the allowance.

There are a number of rules allied to this new concession, however, the key point to remember is that the maximum nil rate band (NRB) percentage anyone can have is 200%. This means that if you benefit from a 200% allowance and you re-marry you must make sure each spouse writes their will to gift their NRB to a trust or chosen beneficiaries on first death.

As with everything to do with tax, documentation is everything. There is a really useful HMRC form (IHT 401) available online to check whether you have more than a 100% allowance.

5.1 An Immediate Post Death Income In Possession Trust (IPDI)

An IPDI is an interest in possession trust created on death where the surviving spouse is entitled to the income from the assets with the capital passing to different beneficiaries on the death of the surviving spouse.

If you do not want your spouse's future partner's children to benefit from your children's share of your joint estate then the IPDI is for you.

If there are sufficient funds to support the surviving spouse then the trustees of the IPDI can make potentially exempt transfers to the capital beneficiaries without waiting for the surviving spouse to die.

If the spouse receiving the income dies many years later the estate benefits from both allowances revalued over the years after the first spouse's death.

If you are happy to allow the flexibility to your spouse then you can authorise your trustees to provide loans to the surviving spouse of up to the entire value of your estate thus simplifying the ongoing management of the estates (although this increases the risk of capital loss).

5.2 Discretionary Trust

It is possible to put the entire estate into trust on first death thereby allowing the trustees to subsequently do whatever is best from a tax planning and personal perspective.

The trustees can allow the surviving spouse to benefit from the trust as well as the intended ultimate beneficiaries, they can create new trusts or distribute all the cash to the surviving spouse. In this way you can be sure that you are not putting the survivor's income at risk by undertaking the planning.

Whilst this form of trust may be over kill for first marriages it can be appropriate for second marriages where the deceased wishes to favour one set of children or safeguard same. Administration can be kept to a minimum by the use of loans to the survivor / beneficiaries. Likewise if the survivor needs to go into a residential home and funds are limited then you will not want to use the transferrable nil rate band as to do so may be giving cash to the local authority.

Please review our notes on using trusts in financial planning

5.3 Using Your Property For Part Of Your Nil Rate Band Trust

This now only applies in the circumstances mentioned above for a Nil Rate Band Trust (NRBDT). Where a person wants a trust on first death and has not got ready funds their share of the property can form part of the NRBDT. To achieve this, the property has to be owned as "tenants in common" which is a legal state where you own your share of the property completely separately (as opposed to the normal joint tenancy whereby you both own all the property together). Such action can save significant amounts of IHT on the transfer of a large property.

Please see our article '*IHT & The Family Home'* for further information.

5.4 Business

It is worth considering placing any assets with business property relief (BPR) in a separate discretionary trust for the benefit of the surviving spouse and the children. This may be effective at saving IHT on the business on second death, if the business is sold after the business owner dies.

5.5 Pension Plans

Again, if you have substantial pension plans and/or death in service benefits these can be nominated (or written directly) into a discretionary trust. Like the business assets the proceeds are free from IHT.

Please see our notes '*IHT & Pensions'* for further information.

5.6 Charitable Gifts > 10% Of Your Estate

If you gift more than 10% of your taxable estate to charity the rate of IHT will be reduced to 36% meaning in some instances the beneficiaries get more net if you gift more.

The net value of your estate is the sum of all the assets after deducting any debts, liabilities, reliefs, exemptions and the nil-rate band.

A qualifying charity is an organisation that is recognised as a charity for tax purposes by HM Revenue & Customs (HMRC). For inheritance tax purposes a Community Amateur Sports Club (CASC) is also treated as a qualifying charity. You can check this by asking the charity to confirm that it has an HMRC charity reference number.

As with everything nowadays gifting to charity is not as straightforward as the above HMRC explanation makes out. However the Society of Trust & Estate Practitioners (STEP) has now produced a wording designed to meet the new requirements so any good STEP lawyer should be able to incorporate the correct wording into your Will.

Having dealt with several Wills where significant monies are given to charity we very much favour the discretionary trust approach so the charities do not know what is coming to them until the trustees are ready to distribute. This prevents harassment from the charities which can be very intrusive and time consuming.

For those interested further information this can be found at:

http://www.hmrc.gov.uk/inheritancetax/pass-money-property/charity-reduce.htm

5.7 Post Death Planning

Some would say surprisingly there has been no attempt to change the provisions which enable the variation of a Will by the Wills' trustees within 2 years of the date of the death of the testator. This in effect means that if you discover the Will has created a position you are not happy with you can simply rewrite it to best effect! Potential use of this variation/disclaimer can be to resolve ambiguities within a Will, to achieve fairness due to changes subsequent to the Will being made, and obviously to save a bit of tax. This is a hugely important tax planning vehicle which we expect to be curtailed in some way in the near or distant future.

5.8 Safeguarding Assets Against Care Home Fees

One big advantage to using trusts on the first death is that a transfer into trust may well safeguard the deceased partner's assets from local authority means testing should the surviving spouse have to go into a home and thereafter require local authority funding.

There is also a perverse rule which states that the local authority will not "top up" an individual's funds to allow them to stay in a better home however a third party may top up the local authority funds to achieve the same end. A trust structure therefore can both protect assets and help the surviving spouse by topping up the bare minimum local authority contributions to a more pleasant alternative.

It is worth noting that many remaining spouses have sufficient assets never to require local authority assistance with fees so be careful not to wreck tax planning for the sake of avoiding subsidies which may never be available.

6. LIFE INSURANCE

If you have substantial lump sum life cover this can be written into trust to mitigate IHT.

Post October 2014 there is a question mark as to the possibility of a periodic IHT charge. This would apply after death and before distribution and could result in as much as a 6% IHT charge. Nonetheless 6% is a great deal better than 40% and you can mitigate some / all of this by writing your life insurance into “Rysaffe” type trusts.

7. EXEMPT TRANSFERS

These are gifts, which are not subject to IHT at any time.

- Your husband or wife
- Charities
- Political parties (surprise surprise!)

8. TRUSTS USED TO PASS ASSETS FREE FROM IHT

8.1 IHT Planning For The Business Owner

A major IHT concession is the business property relief (BPR) provided to the business owners of a trading company. In essence, one gets 100% IHT relief after owning a business for 2 years and you get full CGT uplift on death. This means that there is very little point in giving away businesses and you can gift your business into a chargeable discretionary trust on your death which in itself will cut out the potential for IHT if the business is subsequently sold by your surviving spouse. In essence, if you only run a small trading business you should get a 100% relief from IHT. If it is a quoted company the relief drops to 50% and if you have land, machinery or plant moved by your business you will get 50% relief on this as well.

As ever you have to have a qualifying business which in essence precludes any business which manages stocks and shares, lands and buildings or simply holding investments would not qualify. The test is an all or nothing test so if your business is 50.1% trading you would qualify for 100% relief, if the business is 49.9% trading you will not get any relief at all.

There are many cases where the arguments of what consists of wholly or mainly a trading company and this particularly applies within the farming community where you have very substantial capital employed (ie the land of the farm) and you may also often have substantial lettings or farm buildings etc. which in themselves generate investment income. Likewise, caravan sites are a renowned battle ground between the HMRC and the taxpayer and great care needs to be taken here as well.

Many farmers in particular maintain their farms into retirement in an effort to reduce IHT liability. HMRC have in recent years sought to curtail the availability of business relief in particular with regards to farmhouses. HMRC might compromise on say 70% relief on farmhouses, although on a true working farm the residual land should get 100% benefit.

8.2 Pensions and Life Assurance Trusts

See 5.5 and 5.6 above and our other note '*IHT & Pensions*'.

9. LIFETIME GIFTS

It is important to bear in mind, before divesting assets, the reduction in state support and the likely need to provide your own pension, your own health care and nursing or residential home without expecting state help. It is, therefore, essential either to maintain sufficient assets to cover these or to have taken out insurance cover to deal with these possible liabilities before you make any substantial gifts.

Lifetime giving must be done only after the most careful and cautious estimates of your future needs. Regard must be had to the possibilities of reduced interest rates, Stock Exchange crashes (say affecting your pension income), and children's divorces, separations, or ill health. It should also be borne in mind that, in assessing capital qualifications for support, assets previously given away can be counted as current capital, though this is less likely to occur where the date of the gift of capital and the claim for support are considerably distant in time.

If you do decide to undertake any planning then it should be flexible to allow for changes of circumstance e.g. divorce, unexpected births, deaths in the wrong order, changes of government, altered relationships etc. Any plans should also be ones which the family can understand carry out and live with without strain.

9.1 Potentially Exempt Transfers (PETs)

PET provisions allow you to gift substantial sums now, and after 7 years (subject to some complex aggregating rules) the money may fall outside your estate. You can combine the gift with an insurance plan to protect your possible IHT liabilities if you wish, and there are some whizzo plans available which give you some access to your cash without infringing on the "gifts with reservation" rules.

With the transferrable nil rate band provisions, more and more IHT planning is revolving around £650,000 of PETs being made every 7 years.

Please note the new relevant property tax rules which may well mean you have to pay 6% IHT every 10 years on the value of your accumulative post April 2014 trusts less your trust allowances.

9.2 Annual Exemptions

You can gift up to £3,000 each per year to chosen beneficiaries free from IHT (£6,000 in total for a married couple). You can also relate these gifts back one year meaning that you could gift a total of £12,000 now.

You can also gift up to £250 to as many people as you like. If it is £251, however, it counts towards the annual £3,000 allowance.

9.3 Gifts In Consideration Of Marriage

With the average marriage costing greater than £15,000 these limits could be very useful. The maximums are:

- £5,000 per parent (maximum £20,000 per marriage)
- £2,500 per grandparent (maximum £20,000 per marriage)
- £1,000 from anyone else (no limit)

A point to note is that the gifts must either precede the marriage or be made in fulfilment of a binding promise made before the marriage in order to be treated as 'in consideration of marriage'.

9.4 Gifts Out Of Income

You can exceed the annual £3,000 limit as long as you can prove the gift does not affect your standard of living in any way. This is a very common exemption which we use extensively for clients with annual figures exceeding £50,000 not being unusual.

As with every other aspect of tax planning it is important to document gifts and to demonstrate that, for instance, a gift out of income does not affect the individual's living standards and is a true gift.

9.4.1 Gifts Directly Into A Pension Plan

Parents can make gifts directly into pension plans on behalf of their children and grandchildren. This achieves tax relief at the child's highest rate as well as acting to possibly save IHT.

Please see our article '*IHT & Pensions*' for further information.

10. INVESTMENTS WHICH ARE IHT FRIENDLY

You can invest in a range of investments which are free from IHT. Typically the investment must be held for 2 years before IHT exemption. Examples of such investments are:

10.1 EIS and AIM Holdings

It is possible to invest in smaller companies whose shares are quoted on the Alternative Investment Market (AIM) as 100% IHT exemption is available for shares in trading companies held for 2 years or more, via qualification for business property relief (BPR).

We have extensive experience of AIM/EIS/VCT schemes. Your chances of losing substantial sums on these investments is very high and unless you are considering a substantial sum in a widespread portfolio run by a good specialist stockbroker we would advise against the risks involved.

10.2 Woodlands, Forestry and Farming

Forestry qualifies for IHT, CGT and income tax exemptions once held for 2 years. There are collective schemes we have looked at in the past, however, the investment returns on the whole have been poor. It is reasonable to say that the risk of substantial losses is less than for most other schemes mentioned here, but again we would suggest such schemes are most appropriate for the larger estates.

10.3 The Marital Home

Please see our article '*IHT & The Family Home'* which explains some of the current crop of alternatives to mitigate IHT on property.

We have separate notes on tax efficient investments which will provide more information on these schemes and we have separate notes on equity release products if you are interested.

11. INHERITANCE TAX SCHEMES

IHT specific schemes are talked about a lot but are rarely implemented. Many of the more effective versions are squashed fairly rapidly after they have proved to be successful. Whilst we are aware of certain high risk but potentially very rewarding arrangements these are not for a general discussion paper such as this and would certainly not be for the faint hearted! The following are, therefore, the most commonly used means of reducing IHT.

11.1 Gifts Into Trust

You can obtain holdover relief by gifting to most trusts other than a bare trust and a settlor interested trust. Once within the trust the growth is outside your estate as is the gift after the 7 year period. With certain investments (ie bonds) you can assign the asset out of the trust to a beneficiary in order to avoid the discretionary trust 45% rate of income tax and/or to use the beneficiary's full annual CGT allowance.

Gifting into trust has the huge benefit that as a trustee (or as the person who appoints the trustees) you are able to control what happens to the money within the trust although you must remember of course that you are not allowed any benefits. The growth remains outside your estate and you can keep the tax down on the growth reasonably well by the above mentioned assignments.

Clearly, if the donor is in ill health there is no point in trying to get holdover relief as CGT dies on death and, indeed, you need 7 years to get the main benefit for a PET. Nevertheless where you have 2 spouses in good health, £650,000 into a discretionary trust makes a very good long term estate planning vehicle (see our notes “using trusts in tax and financial planning”).

Most suitable trusts for this purpose will be subject to a periodic IHT charge of 6% every 10 years and any monies withdrawn from the trusts will be taxed proportionately.

11.2 Discounted Gift Schemes (DGS)

On the face of it a discounted gift scheme is the panacea allowing you to make a gift for IHT purposes which is not a gift with reservation (GWR), is not subject to pre-owned asset tax (POAT) yet allows you access to at least part of your funds. With a DGS you place a capital sum into a trust. This trust invested into an insurance company bond which then provides an income to the settlor from the settlor’s fund leaving the balance of the trust to grow for the benefit of your ultimate beneficiaries. Depending on the level of income you opt for HMRC consider the gift is not the full cost of the investment, but a cost which takes into account the fact that the investment will provide a high level of income to the settlor for the remainder of their life.

The gift is treated as a PET and so falls outside of your estate after 7 years. The income paid to the settlor is usually tax free for up to 20 years as it represents a return of his or her capital. The trust itself can be flexible over the ultimate beneficiaries and, indeed, if required the underlying investment bond can be continued post death as a useful discretionary trust vehicle which provides all the usual safeguards to the ultimate beneficiaries. The trust can be established on a single or joint life basis depending on circumstances.

By way of example these schemes can discount a £250,000 quite substantially:

Male Aged	**Discount**	**IHT Saving**
60	£155,491	£62,196
70	£120,011	£48,004
80	£84,626	£33,850

These are only example figures and clearly would be subject to individual underwriting and Revenue acceptance.

Once you have established the scheme you must stick with the income for the rest of your life. You cannot access the capital, this has been gifted away.

Underwriting is essential to prove that the rate of discount was reasonable bearing in mind your state of health at the time the plan was established. HMRC are going to be most upset if they have given you a 20% discount on a gift to find that you died the next week when clearly no such discount should have been given. However, all is not lost if one half of a couple is in ill health. With a joint settlor DGS the discount is the average between the two settlors. If one is ill then simply no discount applies to their share of the overall gift.

Care needs to be taken when setting up these plans to ensure you have a discretionary trust and bond arrangement as IHT periodic charges will apply and clearly the funds need to be available to meet these. You can avoid the discretionary trust regime by choosing a bare trust for your DGS, however, if your beneficiaries get into trouble their creditors may be able to force an encashment of the arrangement.

For most (particularly those aged less than 80) the costs, lack of investment alternatives and restrictions of these schemes make them unattractive.

11.3 Gift and Loan Plans

Gift and loan trusts are the most tried and tested of the IHT mitigation schemes. The settlor makes a small gift to establish a discretionary trust (some say no gift is required at all) and the settlor makes a substantial loan to the trust. The loan is interest free and repayable on demand.

The trust then makes repayments of the loan to the settlor in the form of income (perhaps 5% per annum) and as it is a return of capital should not generate any tax liability on the settlor. On the other hand the capital sum within the trust is going to grow and this growth will fall outside the settlor’s estate.

As it is a loan, there is no initial gift or IHT consideration. The periodic charge on the discretionary trust has to deduct any loans so it is unlikely that there will be any periodic charge. There is no gift with reservation (GWR) or pre owned asset tax (POAT) problems so you can effectively freeze this element of the estate.

The gift and loan scheme has the benefit that you can have access to your capital at any time by asking for you loan back. The income is tax efficient and you can invest more than the nil rate band. The trust itself would be discretionary and hence protects your beneficiaries from the vagaries of ex-spouses and creditors.

There are some whistles and knobs to this scheme so, for instance, if you are absolutely certain who you want to benefit from the loan and you are not bothered about protecting beneficiaries from creditors etc. you can make the loan trust into a bare trust and have the taxation treated as that of the beneficiary.

Clearly if you are taking your loan back rapidly, you may well run out cash and the growth outside your estate will be lessened. If the settlor dies unexpectedly then it is an idea to leave the right to the loan repayments back to the trust in your Will otherwise there may need to be some unravelling of investments.

The loan trust is a medium to long term IHT planning tool which means it will take time for the assets to grow and hence for the IHT saving to be achieved. Unlike the DGS however, it does not require underwriting.

11.4 Timing

As you will see, the current tax planning strategies recommended by the IHT planning fraternity are to make use of your nil rate band as often as possible. The vagaries of the legislation, however, mean that if you are planning to make use of some, or all, of these plans you need to get them in the right order. For instance, you set up a discounted gift scheme then a couple of weeks later you set up a gift and loan scheme with discretionary trusts then the gift within the DGS will impact on the value of the loan trust for the purpose of the periodic charge. On the other hand, because the loan trust itself does not entail any physical gift if you were to set that up 2 weeks before the DGS neither would affect the other.

In brief, therefore, the golden rule is no gifts of value (gift and loan trusts) followed by exempt gifts followed by chargeable transfers followed by PETs.

11.5 Life Assurance

It is always worth mentioning the ability to pay your IHT in stages. Assuming you are in reasonable health then you can take out a life assurance plan which would pay a substantial sum of money into a discretionary trust outside your estate in the event of your death. This means that you can fund part, or all, of your potentially exempt liabilities whenever they occur.

11.5.1 Regular Premiums

The premiums would usually go into a discretionary trust so would be treated as normal expenditure out of income either within the annual £3,600 limit or within the normal expenditure out of income rules. Whilst in the trust a substantial portion of the premiums in the initial years at least will fund the life assurance element, however, once the trust has been running for a substantial period of time it may well be subject to periodic charges based on the surrender values of the plan at the time. Typically, however, (depending on how you structure the life assurance) the value of the underlying fund (again unless you are in severe ill health) remains below your nil rate band and hence certainly prior to death that it is unlikely that any periodic charge will be made.

11.5.2 By Lump Sum

One can combine a life assurance with an immediate annuity to create useful IHT savings without affecting your net income. These schemes rely on your being in good health at the time of the proposal, but if accepted at normal rates the process can create real IHT savings.

11.5.3 Periodic Charge

The value of the plan for the periodic charge is the premiums or fund value whichever is the greater. This means it is unlikely the periodic charge will affect term life plans (unless of course the individual is very ill at the 10 year anniversary) however it could be possible that tax is due on the surrender value of a whole life plan.

12. SUMMARY

Almost without exception IHT planning is undertaken for those who are past, or near, retirement. Whilst paying the government tax twice on your earnings (ie once when you earn the money and again after you die) is irksome to all. The priority for this firm is to ensure the wellbeing of our clients now and it is essential that we ensure you have sufficient funds for your needs first before depleting your assets to give funds to beneficiaries.

Differing types of business structure and individuals varying needs produce a wide variety of IHT and financial strategy solutions, and it is important to ensure that individual circumstances and priorities are identified. For these reasons, professional advice should be sought before taking, or not taking, any action. These brief notes consider the structure of IHT, and the planning implications of that structure with regard to life and death planning of estates. The tax has many technical problems. It is, therefore, essential to take advice on specific issues.