User Guide

PEARSON
SOLICITORS AND FINANCIAL ADVISERS

Beginner's Guide To Inheritance Tax

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Inheritance tax (IHT) has traditionally been seen as a tax only for the very wealthy. However, with a threshold of £325,000 (£650,000 for married couples and civil partners) and the price of houses still relatively high, even after recent corrections, more and more people are finding themselves caught in the trap. This could lead to many people having to sell long held family heirlooms or investment assets to meet tax bills which a little bit of planning could help avoid.

What is Inheritance Tax?

Inheritance tax is payable when someone transfers ownership of their assets, usually on death. Each individual is entitled to a nil rate band, under which no inheritance tax is payable and traditionally very few estates have exceeded this nil rate band.

However, despite recent corrections, the house price boom of recent years has pushed more people into the IHT net. Alongside ISAs, death-in-service benefit, foreign homes or less obvious assets such as paintings or cars, this has boosted the value of an average estate.

Indeed, even after the housing market started to fall in 2007, the Treasury's 2008/09 receipts from IHT payments were still up 20% on 2002/03.

The tax rate for all assets over the nil rate band is 40% so it is possible to build up a large bill quickly. Also, inheritance tax becomes payable relatively quickly. It is due six months after the end of the month of death.

This doesn't give the administrators much time to, say, sell a house, or liquidate other assets if that is necessary. With that in mind, if you unexpectedly find that your estate now exceeds the HM Revenue & Customs limits, what can you do?

What Are The Exemptions?

Although the Government closed many of the loopholes on inheritance tax in the 2006 budget, a number of exemptions and allowances DO remain. Where possible, you should aim to maximise use of these exemptions and allowances IF YOU WISH to pass as much of your hard-earned cash onto your heirs as possible.

In addition to the £325,000 nil rate band available on each estate, transfers between husband and wife or between civil partners are tax free. Since 9 October 2007, such legally recognised partners can also pass over any unused portion of their own nil rate band so that, in effect, the surviving spouse has up to £650,000. However, this does not apply to cohabiters or 'common-law' spouses.

The majority of other exemptions and allowances come about through distributing some of your wealth prior to death. Such assets transferred prior to death are termed 'potentially exempt transfers' (PETs) for IHT purposes, potentially exempt, because, from the day you give them away, the tax due on death is subject to a tapering over 7 years, starting at 100% of liability for the first three years then falling proportionally from 80% over the next four. If you survive the full seven years, the IHT liability on that asset is zero.

However, this taper relief does only apply to amounts in excess of the nil rate band. As there is no tax due on the first £325,000, then no taper relief can apply.

Therefore, if you give away anything up to £325,000 and die within those seven years, the full amount of the original gift will be added back in to your estate and tax will be calculated on the total as if you never gave that amount away.

Having said that, if you do survive seven years, then that amount is considered as having left your estate and you therefore get the chance to benefit from the nil rate band allowance a second time.

However, there is an important restriction on PETs called a 'gift with reservation of benefit'. The principle is that if you continue to enjoy the benefit of an asset the transfer is entirely ineffective for inheritance tax purposes. This is in place to stop people simply transferring their homes to their children and continuing to live in them. In order for this to be potentially exempt, a full market rent would have to be paid to the children after transfer.

Gifts of £3,000 or less are allowed annually without being liable for IHT -and if unused, this allowance can be carried forward for one year. There is also a gift exemption applying to 'regular gifts out of income'. These gifts can be as much as you like, but they must form part of a 'pattern of giving' and HM Revenue & Customs must be satisfied that after the gift has been made, you are left with sufficient income to maintain your standard of living.

You are also allowed gifts on consideration of marriage or civil partnership. The amounts vary according to your relationship to the bride and groom - the moment, £5,000 is allowed from the parents, £2,500 from the grandparents and £1,000 by anyone else. Gifts to charities also fall outside inheritance tax.

Taking Practical Steps

To make sure you make full yet practical use of your allowances and exemptions, there are some basic steps you can take. Planning ahead is very important.

Step One - the basics

Making a will is vital. If you die 'intestate' (without a will), your estate will be divided up according to the rules of intestacy. This is particularly important if you are not married, because you would be unlikely to inherit a 'common law' partner's money, or even their share of your house.

For example, under the laws of England & Wales (the Administration of Estates Act 1925). your legal spouse receives £250,000 plus a life interest in half the remainder of the estate and your children will get the balance at 18. If you have no children, £450,000 passes to your spouse and the remainder is divided one half to your spouse and the other half to your parents or siblings. If you have no spouse and no children, it will pass to your parents or then your siblings. If you have no legally recognised family, it goes straight to the Crown.

Note: In Northern Ireland, the intestacy rules are similar to these, however, in Scotland, the rules are quite different.

Here, the intestacy laws are governed by the Succession (Scotland) Act 1964 which makes the situation a little more complicated. Please check with your solicitor or adviser to understand how the laws apply in your location.

Step Two - use your allowances

The basic allowances available have been outlined above. Considering how you can use these in advance will help you manage the assets and any cash flow associated with a 'pattern of giving'. In addition, if you can start giving away some of your assets as PETs when you are still in robust health and likely to live another 7 years, it will save you worry nearer the time.

Step Three - using trusts

Trusts have long been seen as an easy way to brush off an inheritance tax liability. If this were ever the case, it certainly isn't after the 2006 Budget. This closed down many of the tax planning opportunities for investors. Under the new regime, interest in possession (IIP) and accumulation and maintenance (A&M) trusts (until that point the most popular vehicles for IHT planning) became subject to the same IHT treatment as discretionary trusts. Transfers into most IIP and A&M trusts over the donor's nil rate band are now immediately liable to IHT at 20%. These trusts are also liable to a periodic charge of up to 6% every 10 years, and an 'exit' charge when funds are taken out of the trust.

However, despite their diminished tax advantages, these trusts are still useful because they allow for the 'regeneration' of the nil rate band every seven years. If a donor has put money into one of these trusts, they will pay the 20% tax on anything above the current nil rate band of £325,000. If the donor dies within seven years, taper relief will apply to the balance of the full 40% IHT due after three years. If they survive seven years, the donor will have the chance to use their nil rate band again.

Step Four - consider life assurance

Life assurance can be a useful way to accumulate enough money to pay your inheritance tax bill and when placed in trust (and funded from regular income as part of a 'pattern of giving'), is also free from inheritance tax - ie: you do not create an additional IHT burden because the trust keeps that lump sum payment out of your estate.

This can be particularly useful from a liquidity point of view, as the lump sum will be readily available to your beneficiaries to pay the taxes whilst the estate itself is being unwound.

Other Inheritance Tax Planning Tools

Discounted gift plans are basically investment bonds, wrapped in a trust, designed to minimise, although not eliminate, IHT liabilities. You can put a lump sum into a plan and then take up to 5% of the capital out tax free each year.

At the point at which you put money into the plan, a designated discount rate decides how long you are likely to live, how many years the 5% is likely to be paid out and therefore how much of the trust is 'yours' and forms part of your estate.

The remaining assets, including any growth, are free from tax providing you survive 7 years. However, these schemes do depend on having disposable cash, a need for income and a reasonable expectation of surviving the full 7 years.

Investments Providing Tax Releif

Most investments will be subject to inheritance tax, including ISAs, property, art, wine and foreign property. However, a number of investments do qualify for IHT reduction or relief. For example, if you have held shares in an Enterprise Investment Scheme (EIS) for more than two years, it will fall out of your estate for inheritance tax purposes.

However, an EIS involves investing your money into unquoted companies and you therefore run a higher risk than other investments of losing some or all of the value. Consequently, you need to be certain that you are comfortable with this additional risk before considering the IHT benefits. Ultimately, having to pay out 40% of something is better than saving 40% of nothing. Having said that, if you are a business owner, the benefits may help you pass on your own company, providing it meets certain criteria.

There are also two types of tax relief available for investments into business or farming - business property relief and agricultural property relief.

To speak to a solicitor about any of the issues raised in this User Guide, please call **0161 785 3500**
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