

Inheritance tax planning

Inheritance tax (IHT) has in the past been mainly a problem for the very wealthy – who were generally well-placed to find ways of mitigating it. However, strong growth in property prices in recent years has resulted in many more individuals being caught in the IHT net

Given that most of us are keen for our families to benefit from our estates after our death, what can be done to minimise the potential inheritance tax liability?

First, let's be clear: minimising liability to IHT, these days, focuses largely on reducing the value of your estate before you die. That in itself can be a troubling prospect for many older people, who understandably feel they might need access to all their wealth if it comes, for instance, to paying for long-term care. It's important, therefore, to take advice, and to be sure that you understand the possible implications of any tax-planning strategy.

Exempt gifts

The simplest option, open to anyone with some money they can afford to pass on during their lifetime, is to make outright gifts using the IHT exemptions available. These fall out of the estate as soon as they are given (unlike other types of gift), as we'll see.

The term 'outright' is critical: it's important not to retain any use or benefit from your gift, or it will be treated as a "gift with reservation of benefit", which still counts as part of your estate for inheritance tax purposes. So, if you give your house away to your children, you cannot then continue to occupy it (unless you pay a market rent).

As for exempt gifts, everyone has an annual exemption of £3,000, which means you can give £3000 a year to anyone you wish, without IHT implications. You can also carry your annual exemption (or any unused part of it) forward one year if you don't use it in a particular year, although you cannot carry it forward again to subsequent years.

Additionally, everyone may give away any number of small gifts of up to £250 in the same tax year, as long as each gift is to a different person. But you're not allowed to give the same individual a large gift (up to £3,000) and a small gift in the same tax year.

Wedding (or civil partnership) gifts are also allowed: each parent can give up to £5,000 when a child marries, and the happy couple can also give each other up to £2,500 before they tie the knot. Grandparents can give up to £2,500, and anyone else has a £1,000 limit.

Married couples are in a strong position because they have two sets of exemption to use up each year.

Another often overlooked exemption is the capacity to make gifts from everyday income. In other words, provided you can demonstrate that your gifts – of whatever size – are not undermining your standard of living or eating into your capital and that they are regular (even if they are not necessarily worth the same amount), they should fall straight out of your estate. Such an arrangement could work well, for example, when a grandparent is prepared to help with school fees from spare income.

But be sure to keep full records if you're going to take this path. You should keep detailed annual accounts of salary, investment and other income, together with details of all gifts made, bills paid and other expenditure. It's important to establish a regular pattern of giving – a letter of intent to the donee can provide helpful evidence. In fact, it's important to keep records of any gift you make, including a note of which exemption you are using. Such records may only be examined after your death, but they make the executor's job a lot easier.

Potentially-exempt transfers

Any money that you give away during your lifetime that doesn't qualify as an exempt gift will be treated as a potentially-exempt transfer (PET). There are no value limits involved, you simply have to survive seven years after making the gift. Only then does it disappear from your estate for IHT purposes. There's still quite a beneficial tax regime for gifts made to the recipient outright, although the Finance Act 2006 clamped down on those made in trust.

So, for example, you can make gifts up to the value of the nil-rate band (currently £325,000) without liability to tax. If you survive seven years after making the gifts, they automatically fall out of your estate altogether, and you can then begin again by making more gifts to use up your 'empty' nil-rate band. If both parents were to follow that strategy for their children, they could pass on £650,000 between them every seven years, at the current nil-rate band level.

If, however, you die within seven years, the gifts must be reported by the executors of your estate, and they will count as the first assets against your nil-rate band, so that it will be at least partially used up before the rest of the estate is assessed. But as those assets would be part of the estate anyway, it may be a strategy worth following, particularly if you're fit and well.

PETs over the value of nil-rate band will be chargeable to inheritance tax if you die within seven years, but there is a sliding scale – known as a taper relief – which reduces the rate of tax payable if you survive between three and seven years after making the gift (from 40 per cent if you die within three years to just 8 per cent if you survive more than six). That can make them valuable for wealthy people who are able to give away, for example, £500,000 of assets as a PET. If they survive seven years, the entire gift is outside their estate altogether – but even if they live only five years, for example, the rate of IHT payable on the £175,000 above nil-rate band will be 16 per cent instead of 40 per cent.

It's important to be aware that, if you don't specify otherwise or take steps to provide for a possible IHT liability, the subsequent tax burden will fall on the recipient of the gift, rather than on the estate itself. This is often not what the donor would have wanted, particularly if the money was intended for something like the deposit on a child's first property.

To prevent this, one option is to take out life insurance against the risk of dying during the critical seven-year period after the PET was made. The payout diminishes over time, to take account of taper relief, as the seven years pass. It's a useful protection and, if you're in your 60's, for example, and in good health it is not overly expensive.

However, for older or frailer donors, the rates charged for such cover may be too high to make it worthwhile.

It makes sense to give away assets that are likely to increase in value – for example, private company shares, or art by a living artist not only to remove the future growth in value from your estate, but also as the relevant value for IHT purposes will be the value as at the date of the gift (rather than at the date of the death). You do need to consider capital gain tax liabilities however, as HMRC treats a gift as a disposal, just like a sale.

100 per cent relief

Certain kinds of investment are given full IHT relief. They are normally however, relatively illiquid assets. They include business assets, such as shares in unquoted companies (a family business, for example, or Aim-quoted shares) or factory premises (50 per cent relief only), and agricultural property (though not 'lifestyle' farmhouses). Payment of IHT can also be postponed on woodland until the timber has been sold.

Tax-efficient wills

To minimise the tax due, it's important for married couples and civil partners to make tax-efficient wills. If they simply leave everything to each other, on the death of the first partner all the assets will pass straight to the survivor. There will be no IHT to pay due to the exemption on gifts between spouses. Additionally, since the Finance Act 2006, you can transfer any unused Inheritance Tax threshold from a late spouse or civil partner to the second spouse or civil partner when they die. This can increase the Inheritance Tax threshold of the second partner - from £325,000 to as much as £650,000 in 2011-12, depending on the circumstances.

Despite the changes brought about by the Finance Act 2006, wills and trusts still remain an important estate planning mechanism.

Transfers between husband and wife are exempt for Inheritance Tax and therefore no Inheritance Tax is payable on the death of the first spouse. However on the death of the surviving spouse, Inheritance tax is payable on their estate if it exceeds £650,000. Inheritance tax is charged at 40% on the balance over this threshold.

A straightforward Will giving everything to your spouse does not pay any Inheritance Tax. You could have gifted away up to £325,000 (e.g. to children) without Inheritance Tax being payable and given the rest to your spouse, but this could leave your spouse in a difficult financial position.

For unmarried couples, or friends or siblings who live together, and jointly own a house, there's no kindly spouse exemption on the first death. The Danger is, therefore, that the survivor will have to sell the family home in order to meet the inheritance tax bill on the share of the property belonging to the first to die. It's a strong argument for getting married or having a civil partnership. Otherwise, you have the choice of either taking out insurance to cover the likely IHT liability on the first death, or buying a smaller house, which frees up assets to pay off tax bill when it arises.

A properly drafted will could save substantial amounts of tax. For most people there is probably little point in passing down more than the nil-rate band on the first death because it could involve paying tax earlier than necessary. Any excess would probably be better used as a tax-free transfer to the surviving partner, who could then make a potentially exempt transfer (PET) to the next generation (if that option is still available), after assessing his or her financial circumstances. There can still be a tax advantage in using the nil-rate band on the first death, if it is likely that assets passed down will appreciate in value at a greater rate than the nil-rate band will be uplifted.

So called Nil Rate Band discretionary Trusts are no longer necessary for joint estates of less than £650,000 but they are of great importance in other circumstances.

Nil Rate Band planning is not now normally considered for mitigation of Inheritance Tax however it is still used regularly to protect against some or all of the following situations.

- Access to funds by surviving spouse.
- Interest free loans can be made to surviving spouse repayable on his or her death reducing their IHT liability.
- Ensuring that the assets held in trust are not assessed as capital of the surviving spouse should he or she require long term care.
- Guarantee that the trust assets pass to your children rather than say your spouse's new partner should he or she remarry.
- Protection to some extent against bankruptcy

Joint assets pass direct to the surviving spouse and do not pass under the Will. These joint assets cannot be used to fund the Discretionary Trust Fund. It may be necessary to equalise the respective estates to ensure both spouses have sufficient sole assets to use the Nil Rate Band Discretionary Trust to best effect.

The family home

The largest asset owned in most instances is the family home. Often held by both parties as joint tenants. In order to ensure that each spouse has sufficient sole assets to satisfy a Nil Rate Band Trust it may be necessary to split the joint tenancy of the property. Each spouse would then own the property jointly as tenants in common. Although the property would still be owned jointly with your spouse, the significant difference is that on the death of the first spouse the 50% share owned by them can then be used towards satisfying the Nil Rate Band Discretionary Trusts.

By specialist wording within the trust the surviving spouse can continue to own the whole property but the value of deceased's share in the property will be out of the surviving spouse's estate. Although Stamp Duty Land Tax may be payable at the time of the deceased's death it will only be a fraction of the potential Inheritance Tax (**IHT**) liability. The assets within such a trust arrangement will not be regarded as the spouses capital should he or she require Long Term Care.