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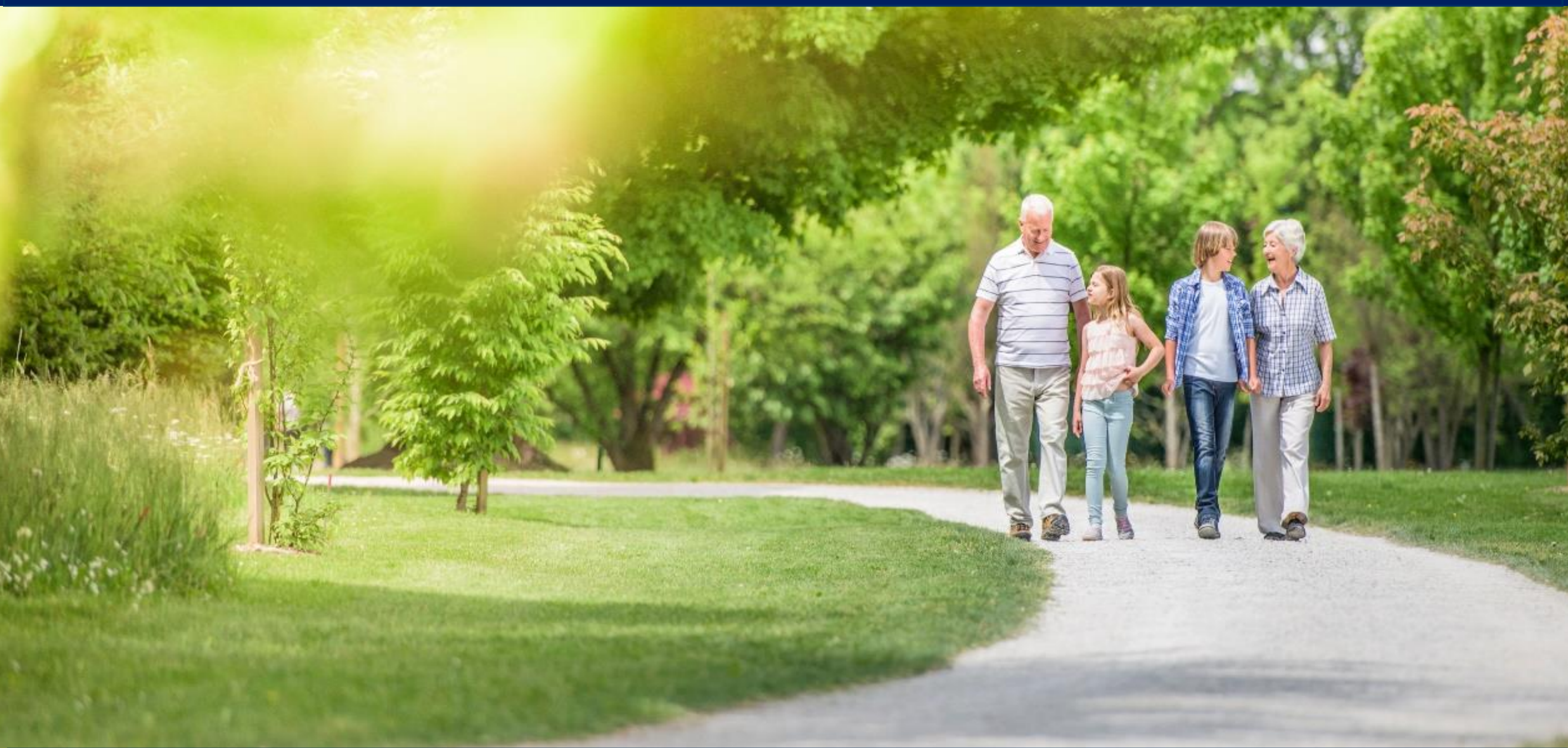
A guide to inheritance tax planning options



Financial planning guide

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Introduction to Inheritance Tax

Inheritance Tax (IHT) is the proportion of wealth taken from an estate by HMRC upon death, calculated based upon the value of a person's assets. It is also payable on trusts or gifts made during a person's lifetime. When payable, this liability leaves beneficiaries with an unwanted, and often unexpected, tax bill. Where an individual is UK domiciled, or deemed UK domicile for IHT purposes, this can be up to a rate of 40%.

Typically, many estates will not be subject to IHT as they are valued within the threshold, known as the nil-rate band. The nil-rate band for 2020/21 is £325,000. However, those estates that do exceed this threshold may be taxed at 40% on the additional balance, dependent on the available main residence nil-rate band.

There are several ways to reduce the IHT payable. Careful financial planning, accompanied by efficiently utilising the various allowances and planning option available, should allow you to best meet your financial objectives.

In this guide we shall introduce the following ways of managing your estate and the arrangements available to reduce your IHT liability:

- Gifting
- Trusts
- Family Investment Companies
- Business Relief; and
- Whole of Life Insurance.

Many individuals find estate planning overcomplicated as there are many reliefs and planning options available. However, working with a financial planner will enable an approach to be taken that is right for you.

We hope that the following information included in our guide can assist you in taking the first steps towards achieving your estate planning objectives.

Allowances and Exemptions

There are several allowances and exemptions available to you which you should be aware of. How you go about utilising these is entirely up to you and should be based upon your own individual financial circumstances, as well as your objectives for the inheritance of your estate. It is important that these methods are used properly, as incorrect use, such as exceeding thresholds, could lead to further tax liabilities.

Nil-Rate Band

The £325,000 nil-rate band will remain frozen until April 2021, at which time it will increase in line with Consumer Price Index (CPI) inflation. Providing there is no remaining main residence nil-rate band, any estate worth more than this amount will be liable for IHT of 40% upon death.

If you are married or in a civil partnership, you are able to leave assets to your spouse or civil partner without IHT being payable. This will not use your nil-rate band which will instead transfer to your spouse or civil partner. This means that for the current tax year the nil-rate band would equate to up to £650,000 upon second death.

Main Residence Nil-Rate Band

The main residence nil-rate band (RNRB) has been phased in by HMRC and applies to deaths which occur after April 2017. It is available in addition to the standard nil-rate band threshold of £325,000 (2020/21). In essence, the RNRB is an initiative intended to protect, where possible, the family residence from IHT, but only where it is being passed on to children or grandchildren.

The value of the RNRB will be as follows:

- £175,000 per person in 2020/21
- Increasing in line with CPI inflation thereafter

Similar to the standard nil-rate band, the RNRB is transferrable on death between married couples and registered civil partners.

Non-exempt assets

These are the assets which make up your estate and will be considered by HMRC in relation to your IHT liability. These include, but are not limited to:

- House(s)
- Other property and land
- Most savings and investments (including ISAs)

However, these can be transferred to your spouse or registered civil partner free from IHT. They will then remain as non-exempt assets in the hands of the surviving spouse or civil partner.

Gifting

You can make gifts to certain individuals and organisations without having to pay inheritance tax.

All gifts and transfers between married couples and civil partners are deemed exempt for inheritance tax purposes.

You are also able to make use of the following additional exemptions:

- Annual exemption of £3,000 in each tax year. If unused this can be carried forward for one year.

- Each parent is also able to gift up to £5,000 as a wedding gift, with grandparents and great grandparents able to gift up to £2,500 each; any other individual is able to gift up to £1,000.

- Small gifts of up to £250 can be made to as many individuals as you wish in one tax year. These are also deemed to be exempt from inheritance tax.

- Regular gifts that are part of your normal expenditure are also exempt from inheritance tax, providing that you have enough income remaining to maintain your normal lifestyle.

Providing that you ensure gifts are within the applicable allowances, gifting is an effective way of reducing the value of your estate for inheritance tax purposes.

Potentially Exempt Transfers (PETs)

These are absolute gifts, which are typically made directly to individuals or bare and absolute trusts.

Providing that you live for seven years after making a cash gift or transfer of assets, you will not be liable for IHT. However, if you die within the seven-year period the gift will no longer be exempt, rather it shall be taxable in line with the standard nil-rate band.

Taper relief is applied should you die between three and seven years after the gift was made.

You are unable to gift or transfer an asset whilst having a remaining interest in this. Where this is the case, the asset will still form part of your estate for IHT.

Chargeable Lifetime Transfers (CLTs)

Unlike PETs, these transfers are paid into trusts and are neither exempt, nor potentially exempt.

A CLT becomes immediately chargeable if it exceeds the standard nil-rate band (along with other transfers within the seven-year period), with any excess being liable at a tax rate of 20%.

The transfer will not be included in your estate for IHT purposes should you die after seven years.

Taper relief may be available should you die between three and seven years after the gift was made, however the tax will be applied at death rates.

If you are considering making lifetime gifts, it is imperative that you are able to establish any new IHT planning structures in an efficient manner. It is recommended that in these instances you speak with a specialist financial planner.

Trusts

Discretionary Trust

The creation of a Discretionary Trust is viewed as a Chargeable Lifetime Transfer (CLT). Where the amount of the gift into the Discretionary Trust is within the settlor's nil-rate band, there is no immediate charge to IHT.

The settlor is the person who puts assets into a trust, and they will often decide how the assets in a trust should be used. This is usually set out in a document called the trust deed.

However, where the value of the gift exceeds the settlor's nil-rate band, the CLT is immediately subject to IHT at 20%. This only applies to the excess of the value of the gift made into the Discretionary Trust above the nil-rate band. If the nil-rate band is exceeded on the creation of the trust, there would be further inheritance tax to pay if the settlor died within a seven-year period.

On every tenth anniversary the trust will be assessed for inheritance tax at a maximum charge of 6% of the excess of the value of the trust fund over and above the nil-rate band.

Associated risks

- Trustees have the authority to make investment decisions on behalf of the trust

- Potential beneficiaries of a Discretionary Trust only have a right to be considered for distributions. The final decision rests with the trustees

- If you die within the seven-year period IHT may become payable.

Suitability

A discretionary trust is suitable for those who would be gifting a sum which does not exceed their available nil-rate band.

This trust is also suitable if you would like a broader definition of beneficiaries, such as all existing and future grandchildren, as opposed to only those existing grandchildren at the time of the trust being set up.

Absolute Trust

Absolute Trusts for your beneficiaries constitute a PET and are created with a capital sum.
If the settlor survives seven years from the date of the PET, the gift becomes exempt from IHT.

However, if the settlor were to die within this seven-year period, the value of the initial gift becomes potentially chargeable to IHT, unless there was an available nil-rate band with which to offset against the value of the gift. In these instances, the value used is, usually, the lower of the value of the asset at the time of the PET and its value at the date of death. The PET will be taxed at the lower of the rates of tax applying on death and those which applied when the PET was made.

Any growth on the value of this gift is immediately outside of the settlor's estate for IHT purposes.

Associated risks

- If you die within the seven-year period, the transfer becomes chargeable. In this event, IHT may become payable on the original gift

- An Absolute Trust allows the beneficiary to demand the assets at any time after they reach the age of 18 (16 in Scotland)

- With an Absolute Trust, there is no facility to alter the share of any beneficiary. In the event of the death of a beneficiary before a payment is made, their share would pass under their will (or the laws of intestacy if there is no will).

Suitability

This option is suitable for settlors who are happy for only the specific beneficiaries named at outset to benefit from the trust.

Discounted Gift Trust

A Discounted Gift Trust (DGT) allows you to make a gift for IHT purposes, whilst retaining the ability to receive a fixed income. This fixed income is in the form of regular withdrawal and would be available until death, or until the trust fund is exhausted, whichever occurs first.

To maintain the effectiveness of the scheme for IHT purposes, you should calculate the exact income levels you require from the gifted capital. You are able to maintain regular, fixed, increases to income levels but this must be decided at the outset of the scheme.

These discounted gifts will be either a potentially exempt transfer or chargeable lifetime transfer depending on the type of trust used.

A Discounted Gift Trust will typically offer three trust options. These are:

- Absolute Trust
- Flexible Trust
- Discretionary Trust

Each trust has its own advantages and it is important that the most suitable one is selected based on the settlor's circumstances and objectives.

Associated risks

- Once the arrangement has been set up you cannot deviate from the pre-arranged income levels without risking the IHT effectiveness of the arrangement.

Suitability

This scheme is suitable for individuals where:

- The capital repayments selected at the outset are needed to meet the settlor's expenditure needs
- Access to the full value of the investment is not required
- An immediate reduction to the estate for IHT purposes is sought; and
- The settlor is likely to survive for a further 7 years.

Flexible Reversionary Trust

Flexible Reversionary Trusts provide individuals with a greater level of flexibility and control than many other trusts, including DGTs. Contributing to this is the ability to distribute benefits prior to the settlor's death.

These arrangements typically revolve around the settlor investing in single premium endowment life assurance policies, whilst gifting the benefits into trust. The settlor and spouse are excluded from benefiting from the trust.

During this arrangement, the capital is viewed as a CLT and will not be considered out of the settlor's estate for seven years. At the end of this period the value of the gift removed from the estate will be dependent on the settlor's remaining nil-rate band.

Trustees are also able to defer the maturity date of the investment should they choose to, meaning that the settlor does not receive capital payments not required. This also means that trustees are able to structure policy maturities in line with their expected future expenditure needs.

Associated risks

- It will take seven years for the value of the gift to fall out of the estate's value for inheritance tax purposes
- The value of the gift taken out of the estate will be solely dependent on the remaining nil-rate band of the settlor
- Trustees are able to oppose changes to the settlor's will, if the changes relate to these investments.

Suitability

Flexible Reversionary Trusts are suitable for those likely to live longer than the seven-year period required for the capital to be removed from the estate for IHT purposes.

They are also appropriate for those looking for the IHT savings, the control and flexibility of a Discretionary Trust, but who also prefer to retain access to the gifted capital.

Loan Trust

A Loan Trust involves establishing a trust by lending the trustee a cash sum.

The trustees then invest this cash, typically into an investment bond, for the benefit of the trust beneficiaries. The loan is repayable, in full or in part, on demand. It is often repaid to the settlor by use of the 5% tax deferred withdrawal facility from the bond.

The amount of the outstanding loan remains within the settlor's estate for inheritance tax, however, any growth over and above the outstanding loan is immediately outside of the state of the settlor for IHT.

As the settlor lends the money to the trustees, with the loan being repayable on demand, this is not a transfer of value for IHT and will not result in a PET or chargeable lifetime transfer.

Suitability
This is a suitable option for those who may need access to the capital in the future, to meet care needs for example, and who are not actively seeking to, or concerned about, immediately reducing the value of their estate for IHT purposes.

Family Investment Companies

A Family Investment Company offers an alternative to trust arrangements, enabling significant wealth to be passed on to future generations whilst protecting and retaining control over the assets. The family investment company is formed as a private company and any shares given to family members will not incur any immediate tax charges. After seven years, the full value of any shares that have been given away will pass out of the estate of the family investment company founder.

The day to day control of the company rests with the board of directors. The board will determine what investments the company makes and when dividends are paid to shareholders.

Suitability
Family investment companies are more suitable for those who are familiar with running a company and are less likely to extract income, at least in the short term. Typically, a significant amount is required to establish a family investment company e.g. over £2 million.

Business Relief

Business Relief, formally known as Business Property Relief, is a tax incentive introduced by the government for individuals who invest into specific categories of trading companies.

Initially introduced to allow the intergenerational passing of family businesses without an IHT liability, the relief has since been extended to include the investment of funds into certain types of unquoted firms (i.e. those not on the main stock market). This has become an attractive option for those individuals looking to reduce their potential IHT liabilities as, unlike gifts, once shares are held for two years, they are exempt from IHT, providing they qualify and are held at the time of death. This is often considered to compensate for the risk associated with these investments. Additionally, these investments will not contribute towards the nil-rate band usage and are transferable upon death without resetting the two-year limit.

Eligibility
Not all companies qualify for this relief. Business Relief only applies to those companies which are not on the main London Stock Exchange. Businesses must not be trading stocks and shares, land or buildings in order to be eligible for Business Relief.

Providing they meet the required conditions; Business Relief is available in full on the following corporate investments and family business transfers.

- A business or interest in a business
- Any shares in an unlisted company.

You are able to gain 50% relief on:

- Shares controlling more than 50% of voting rights within a listed company
- Land, buildings or machinery owned by the deceased and used in a business they were a partner of or controlled
- Land, buildings or machinery used in the business and held in a trust that it has the right to benefit from.

Please also be aware that whilst there is no minimum contribution for individual shareholdings, a minimum investment of £25,000 may be required for packaged schemes.

Associated risks

- These investments will not be IHT exempt in the event of your death for the first two years
- These investments are made into unquoted or Alternative Investment Market listed companies, which are widely accepted to be of a higher risk than those listed on the main London Stock Exchange. Due to their volatility you could lose some, or all, of your investment should the value fall or if the company should fail
- Regular income withdrawals you make will erode your capital value should they exceed the growth rate of your investment
- Any capital withdrawals will no longer qualify for IHT relief
- There is no guarantee of the level of income or capital gains. The performance of an investment will be solely reliant on the performance of the investee company
- Tax rates, benefits and allowances are based on current legislation. This is subject to change and is therefore not guaranteed
- Should the government amend or abolish Business Relief in the future, you may be left with an unattractive asset. Business Relief is currently subject to review by the Office of Tax Simplification.

Suitability

Typically, this option would be suitable for an investor who does not want to give away significant sums of money, but who would like the inheritance they plan to leave behind to be invested. Business relief is also suitable for those who wish for the money they invest to become IHT exempt quickly.

Investments such as this are not appropriate for everyone; your financial circumstances and objectives will often decide on the suitability and practicality of these options to you, hence professional advice should be sought prior to any decision to invest.

Agricultural Property Relief

If you own agricultural property and it is part of a working farm, you can pass on some of your property free of IHT in your will or before you die.

Agricultural Relief (APR) allows for an IHT reduction of up to 100% on farmland, farm buildings, farmhouses and farm cottages.

APR differs from Business Relief as whilst you cannot claim the latter whilst you are letting out your land, you are able to do so with APR. Although this will have repercussions relating to Business Relief claims, as well as APR claims on farmhouses.

Eligibility

Not all farms will qualify for this relief. To qualify for any IHT relief the property in question must have been either occupied by the owner for agricultural purposes for a minimum of two years prior to the gift being made or must have been owned for seven years and occupied by somebody else for the purposes of agriculture throughout that period.

You are able to gain 100% relief on:

- Farmland
- Farm cottages (providing that the conditions of the character appropriation test are met)

You are able to gain 50% relief on:

- Farmland that was let before 1 September 1995 and where the owner does not have the right to vacant possession with 24 months

Farm equipment, recreational riding or grazing horses and derelict buildings are among the assets which will not qualify for APR, although the former may qualify for 100% Business Relief.

APR will not be available where there is a binding contract of sale in place.

Associated risks

- The value of assets such as farmhouses is based solely upon their agricultural value, not on the worth of the property in a non-agricultural capacity.
- Where your land has the potential for development (hope value), i.e. is valued at £10,000 but could have a future value of £80,000, it is likely that you would be better off continuing to farm it.

Suitability

APR is suitable for individuals whose working farm meets the criteria. Where applicable it may be more suitable to utilise Business Relief over APR.

Pensions

In most cases, lump sum death benefits from pension schemes are paid out free of inheritance tax. This is because, in the majority of pension schemes, lump sum death benefits are paid out at the discretion of the pension scheme trustees/scheme administrators.

Therefore, pension planning and making contributions for yourself or others can be an effective way to reduce a potential inheritance tax liability.

Nomination and expression of wishes

Expressing your wishes in relation to the distribution of your pension after you die is important. Nominating those who you would like to benefit from your pension after your passing ensures that the available payment flexibilities can be utilised.

In the event that an individual does not submit an expression of their wishes, funds will be allocated to a dependent in the first instance. Anybody who is not a dependent would be restricted to receiving payment as a lump sum.

Failing to do this may also slow down the process of paying out the benefit as scheme administrators will look to ensure that payments are only paid to the correct recipients. In a worst-case scenario, in relation to death prior to age 75, if this took longer than two years, it in itself could have tax implications.

Whole of life insurance

Ordinarily whole of life (WOL) assurance is recommended to individuals whose protection needs are likely, or expected, to vary throughout the future.

These policies are written in trust for the beneficiaries in order that the death benefit is outside the deceased's estate and to avoid probate. WOL is not a method of reducing the IHT payable, rather it is a way of ensuring that capital is available upon death so that the outstanding tax bill is paid. WOL is often used in two particular circumstances:

- To provide a lump sum upon death which can be used to meet the IHT liability either in part, or fully.
- To provide the client with inexpensive cover over the short-term, on a maximum cover basis.

These plans can be written on a single life, joint first death or joint second death basis.

There are two forms of WOL, investment based, and non-investment based, both of which have different suitability and risk considerations.

These are often attractive as your health is not taken into account at premium reviews, providing you maintain your premiums. This may mean that you benefit from lower premiums.

Balanced cover: Investment based WOL

These policies start with a higher premium but aim to maintain a more level premium throughout the life of the policy. The aim of this is to provide a guaranteed premium, or to build value in your choice of investment funds.

With investment linked WOL contracts, some of the premium is used to buy life cover, whilst the remainder is invested. The objective is to help meet the increasing costs of the protection benefit in later years, meaning that premiums can remain consistent.

Consistent premiums are reliant on the positive performance of your investment, which cannot be guaranteed.

Associated risks

As with all investment products, there are risks involved with these schemes which you must consider.

- For investment linked WOL contracts, if the investment fund isn't performing well enough to cover the cost of benefits, the provider may suggest increasing the regular contribution or alternatively reducing the sum assured.

- If your protection needs change, the policy is unlikely to be adapted.

- Future claims may be affected if you fail to disclose any requested or relevant information.

Maximum cover: Non-investment based WOL

Maximum cover policies allow you to get a higher amount of cover for a lower initial premium. Premiums are initially lower than with balanced cover as they are used to cover the actual cost of your cover and will not cover the increasing costs in your later years.

Associated risks

- Cover is only maintained whilst premiums continue to be paid.

- Premium reviews are likely to take place, often every 5 or 10 years. Premiums are therefore subject to change at these points.

- The plan never has a cash value.

- To maintain the same level of cover throughout the term of the scheme, premiums will need to be increased.

- If the same level of premiums are required throughout the term of the scheme, the level of cover may need to be reduced.

- If you do not disclose any requested or relevant information future claims may be impacted.

Suitability

WOL cover is recommended for individuals who have sufficient excess income to meet the cost of the life insurance over their lifetime and who wish to adopt a simple strategy to help mitigate the cost of IHT on their beneficiaries.

Other Considerations

There are a number of other measures which you can proactively undertake, such as writing a will, which will assist your beneficiaries in the long term.

Often this provides peace of mind and clarity for the owner of the estate, as well as future beneficiaries.

Wills

Having a will in place ensures that your wishes are followed in terms of the inheritance of your estate. Failing to have a will would leave your estate to be distributed under the laws of intestacy and could result in it being claimed by the government.

Should you wish to leave a legacy for a charitable organisation or political entity within your will, you are able to do so. Such a donation would be exempt from inheritance tax, and, if valued at 10% or more of your estate, would reduce the maximum tax liability of your estate to 36%.

Lasting Powers of Attorney

These powers allow you to designate a person to look after your estate should you lose the mental capacity to do so yourself. They would then be able to follow your existing wishes and objectives relating to the maintenance of your estate.

Basic Steps

Whilst much of the process of planning for the inheritance of your estate is confusing and time consuming, there are a number of basic steps which can be taken in order to set the path for your long-term financial objectives.

Undertaking these basic steps will enable you to gain a better understanding of what you can do, and what needs to be done in order to best achieve your objectives for IHT purposes.

Objective setting

The inheritance of an estate can be a complex issue, so planning for how you would like to distribute your assets can be beneficial.

Do you have an idea of the value you would like to leave to each beneficiary? Or are you aware of how your beneficiaries may pay the IHT due?

By answering important questions such as these and setting objectives in-line with your wishes you will be able to put in place a financial plan for the inheritance of your estate.

Estate valuation

Keeping an accurate record of the value of your estate, including your property, cash, investments and pensions will enable you to calculate what the potential inheritance tax liability may be when you come to pass on your estate to your beneficiaries. This will allow you to plan for how you may reduce this liability.

Record keeping

Ensure that you keep a record of transfers to and from your estate. This will allow your executor or personal representative to administer your financial affairs when you die.

If you make regular gifts out of income as part of your normal expenditure, it may also be beneficial to keep a record of your after-tax income. This will prove that these gifts are regular and that your income was able to cover them in conjunction with your usual day to day expenditure.

In Conclusion

This guide provides you with an overview of the options, and potential, to reduce inheritance tax payable on death.

Failing to plan could leave your beneficiaries with a tax liability of up to 40%, significantly reducing the value of inheritance you leave.

In addition to an effective financial plan, simply maintaining an accurate record of any regularly paid gifts, transfers, as well as your estate's value could help your executor or representative to ensure that only the correct amount of inheritance tax is paid.

Ultimately, the options best suited to you will depend on your financial circumstances and plans for the inheritance of your estate.

How can we help?

Effective estate planning can often be viewed as complicated and unachievable as there are multiple options available. However, discussing your options with a financial planner can make the difference.

At Lucas Fettes Financial Planning our experienced financial planners offer a personalised financial planning service. We can assist you in finding suitable estate planning solutions for your financial circumstances, to reduce the tax liability for your beneficiaries.

Our financial planners will look to assist you with the implementation of suitable and sustainable IHT planning to help you meet your financial objectives. Should you wish to discuss your options and how we can assist you, please get in touch.

Contact us

If you would like to find out how we can help you, through our independent financial advice and guidance, get in touch.

To contact a Lucas Fettes financial planner, call us on 01603 706 820 or email info@lffp.co.uk.

www.lffinancialplanning.co.uk

Important information

The way tax charges (or tax relief, as appropriate) are applied depends on individual circumstances and may be subject to future change. ISA and pension eligibility depend on individual circumstances.

This document is solely for information purposes and nothing in it is intended to constitute advice or a recommendation. You should not make any investment decisions based on its content.

The value of investments can fall as well as rise and you may not get back the amount you originally invested.

While considerable care has been taken to ensure the information contained in this document is accurate and up-to-date, no warranty is given as to the accuracy or completeness of any information.

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