ML FINANCIAL ASSOCIATES

The five major steps you can take to save Inheritance Tax

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Introduction

The number of estates incurring a tax charge under the Inheritance Tax (IHT) legislation appears to be increasing year on year. This is due to a combination of factors including rising house prices and a freezing of the main IHT allowance.

It is somewhat offset, however, by a new tax free band. This increased the amount that can be left free from IHT to up to £1 million for a couple (£500,000 per individual) from 6 April 2020. This new, additional tax free band was staggered in from 2017 and only relates to an individual's main residence if this is left to a direct descendant.

IHT is a tax which affects a relatively small proportion of families but, where it does impact, it can do so with a heavy duty. Yet it is a tax which can be reduced, alleviated or mitigated with relative ease.

We aim, in this guide, to show you how you can take five major steps to ensure that your wealth is protected from IHT.

This is not a technical guide – planning to save or mitigate IHT can involve complex legislation and requires a careful approach based on individual circumstances. You must always seek appropriate advice from an authorised source before

The big picture

IHT is a unique tax in many respects. It is often applied to assets that have previously been subjected to other taxes and is a political 'hot potato'; it causes consternation among the political parties as it polarises people around the question of whether it is appropriate to tax wealth which has been most often built up through prudent planning over many years. It has been radically altered over the years, changing many times in terms of the name (it was called a death duty at one point!), the timing (i.e. when it is charged) and the allowances, limits and rules applying.

At the current time (2020/21 tax year), IHT is normally charged at a flat rate of 40% of any value above the allowance of £325,000 for an individual or £650,000 for a couple. If an estate includes a home, for a couple it rises to £1,000,000 because of the transferable Residence Nil Rate Band (RNRB). IHT is a progressive tax in the sense that it bites ever harder on estates that extend beyond these limits. A lower tax rate of 36% applies where at least 10% of the net estate is left to charity.

To give a current example, a couple whose estate value is £700,000 will have an IHT liability of £20,000 (about 3% of their wealth); for an estate value of £1.2 million, this is £220,000 (nearly 20% of their estate); for an estate value of £2 million, this is £540,000 (27% of their estate). This example excludes the use of the RNRB, which may or may not apply depending on your circumstances.

At a level of £2 million, a couple who have three beneficiaries (three children, for example) and decide to leave their wealth equally to each one, will pay more in IHT than they leave to any one of their beneficiaries!

No doubt it will change again in the future, placing a significant emphasis on making sure that any plan constructed to reduce or remove the future possible tax liability is put together with a great deal of flexibility applied.

Since 9 October 2007, an individual can pass on any tax-free allowance they haven't used to a spouse or civil partner, increasing the amount they can pass on tax free. A married couple can now leave assets worth £650,000 without IHT. The RNRB can also be claimed for both spouses on second death, subject to the various rules affecting its availability.

RNRB

This was introduced on 6 April 2017. An estate will be entitled to the RNRB if the:

• individual dies on or after 6 April 2017

• individual owns a home, or a share of one, so that it's included in their estate

• individual's direct descendants, such as children or grandchildren, inherit the home or a share of it

• value of the estate isn't more than £2 million

The estate will also be entitled to the RNRB when an individual has downsized to a less valuable home or sold or given away their home after 7 July 2015.

The maximum available amount is currently £175,000 per person and is expected to increase in line with inflation, based on the Consumer Price Index, in future tax years.

The current level of £175,000 therefore effectively increases the IHT allowance to £500,000 per person, assuming the above conditions are met and a property forms part of the estate.

Changes to death tax rules on pensions in April 2015 also helped to change the IHT picture and provide for more flexibility in the planning approach.

IHT planning

Unlike other major tax areas (for example, Income Tax and Capital Gains Tax), IHT is relatively easy to mitigate against. It is also worth pointing out, in this day and age of controversial tax schemes, that the nature of tax planning to avoid/reduce future IHT liabilities is not difficult, not 'borderline', not controversial, nor pushing the boundaries. IHT mitigation is mainstream, provided you follow one or more of these five basic steps.

Important notes to consider about IHT planning:

- These five steps are likely to overlap and should be considered as part of a holistic planning approach.
- The financial planning starting point is to work out what your IHT liability is likely to be - not always as easy to assess as you may think!
- This stage is very important as you need to be sure you are likely to have an IHT liability before you start making plans to reduce it!
- Whatever motivation you have to reduce your IHT liability, you should not do so at the expense of ensuring you are financially comfortable in your own lifetime. Your priority must be to make sure that you firstly have your lifetime financial requirements covered before you start tackling your future liability position.
- Individual situations are just that: individual! This means they will also be unique. Any guide or suggested steps to help you reduce your IHT liability can only ever be general and cannot replace the value of specialist and high quality advice. These steps will help you understand the potential options but before you take any action, you should always get a bespoke plan designed for your situation.

An important further factor is this: IHT is about the movement of money or assets between different parties. It is not just about the Inheritance of assets on death. The fact it is called Inheritance Tax is a broad brush term that comes from the historic position relating to this tax. It is also the case that IHT most often applies when someone dies, because this is the common point at which people arrange – through their will – to pass assets to their beneficiaries. However, IHT can (and will) apply at other times in certain circumstances.

Step One: Make a will or review your existing will

If you don't have a will in place, there is a simple way of defining what this means: **the Law, not you, will determine where your assets end up following your death.** Are you happy to have it this way? *Yes, is the answer if you haven't written a will!*

If you don't have a will then you are subjecting your asset position to a point where it is almost inevitable the maximum amount of Inheritance Tax will be payable. There are likely to be difficulties for your beneficiaries in accessing your assets or your assets could wind up in the hands of different beneficiaries than those you would freely choose, possibly including the Crown.

Step one of planning to reduce IHT has to be to ensure that you have a will written. Just having a will, however simplistic, is likely to be a major improvement in terms of your planning; however having the right (and best) wording and instructions in your will can make a major difference to your IHT liability.

In this respect, if you haven't got a will, we strongly urge you to get one in place; if you have got a will in place, we suggest that it is regularly reviewed and if you are now embarking on reducing your IHT liability, it should be reviewed as part of this process.

Where there's a will there's a way….

What can you do using a will to reduce your possible future IHT liability? In some respects, the answer is, on its own, limited! The change that took place in 2007 to allow couples to both utilise their Nil Rate Band of £325,000 (and to allow this Nil Rate Band to be transferable between couples) has made a tremendous difference to the planning process and has largely eradicated the benefit of creating a 'will trust' to make sure that both parties in a legal partnership (e.g. marriage) fully utilise their allowances.

Under the old rules, if an individual did not utilise their allowance, on their death it would be lost.

In this respect, since the change in the rules, a couple now have a total allowance of £650,000 between them (or up to £1 million if the RNRB is available).

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Step One: Make a will or review your existing will

However, wills can be extremely useful in respect of making gifts which are exempt from IHT – such as a gift to a charity – which will then reduce the IHT payable. Gifts to charities will not be included in your estate – plus if you make a gift of 10% or more of your net estate to charity, you can reduce the IHT tax level from 40% down to 36% on the remainder of your taxable amount.

Wills are essential to a good financial planning approach and even if on their own they do not necessarily tackle the IHT bill, the will presents an important first step in ensuring that wealth is passed on to the right beneficiaries in an efficient, timely and organised manner.

Tip: There is a further position that is often overlooked: IHT has to be paid before "Probate" is granted after someone dies and within 6 months of their passing. The executors of the estate often need the Probate application agreed to release the assets to pay the tax, hence the classic conundrum of how do the executors pay the IHT prior to receiving the Inheritance? It is worth making sure this is planned for in advance.

Step Two: Use your allowances and make gifts

The changes made a few years ago to IHT allowances have helped, with all couples now automatically (in the vast majority of cases) having two allowances of £325,000 (this is known as the 'Nil Rate Band'), giving a total allowance of £650,000, ignoring any additional allowance available via the RNRB. This means that single people (those who were never married or in a civil partnership) have an allowance of £325,000, and couples have £650,000. IHT will only be payable on estate values above these 'Nil Rate Band' limits.

The biggest change of all was that the transferable Nil Rate Band could be back-dated; for example, a widow whose husband died 20 years ago will now have this 'double' allowance (subject to previous gifts etc. being taken into account).

1. Allowances are there to be used in their entirety and although the individual allowances can now be transferred between couples fairly routinely, there are still a number of areas where forward financial planning can make a big difference:

2. The transfer of the allowances between couples is complicated where gifts have been made in the past or where gifts could be made in the future. It is important therefore to work out clearly where these complications could 'bite' and to ensure that they are managed to maximise the usage of the respective individual allowances.
3. Allowances are wider than just the Nil Rate Band. There are several other allowances which, if unused, could be lost. For example, every individual can gift £3,000 per year free of IHT. This may seem innocuous but for a 65 year old who does this year after year and who lives to 85, this would total £60,000 that can be given away without any reference to seven year windows (which may apply on larger gifts), without affecting any other gifts or allowances.
4. Gifts can be made on marriage without imposing on any other allowances or exemptions or other gifts. An individual can provide £5,000 to their child on marriage, £2,500 to their grandchild and £1,000 to anyone else. For gifts to be effective from an inheritance tax point of view, they have to be made before a wedding happens.

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Step Two: Use your allowances and make gifts

Another allowance is the ‘gift out of normal income’ allowance. This enables you to make IHT free gifts provided that the value of the gift can be shown to be afforded out of your normal income. There is plenty of scope here to add to, or top up, other gifts and to make regular payments across to beneficiaries. This is one of the trickiest areas of the IHT legislation and requires careful advice to ensure that any use of this allowance is done legitimately and is properly constructed and recorded.

A combination of these small or annual gifts can have a very serious impact on a future IHT bill. For example, over 20 years, a couple with 3 children (who all get married during this time) and who each regularly gift £3,000 and pay out sums from their ‘regular income’, could easily reduce their Estate value by well over £100,000 and possibly much more.

Making more substantial gifts

If you wish to make a substantial gift then it will not be free of IHT if the value of the gift plus your other assets is above £325,000 per donor. This is another complex part of the IHT rules and legislation.

In effect, IHT can be applied to any transfer of money or asset from one party to another regardless of when this happens. IHT is not a death tax (as many call it!) - it is a tax applied to a transfer of assets (which most commonly occurs on death). In this respect, a gift of this type is known as a ‘transfer’.

There are two types of transfer from a tax point of view – a Potentially Exempt Transfer (PET) and a Chargeable Lifetime Transfer (CLT). These can be subject to a tax charge at the point of time when the transfer takes place, at stages later down the line, or on death. In both cases, and with careful planning, these initial or lifetime tax charges can be avoided, reduced or managed (from the point of view of timing) and the gift/transfer can slowly work out of someone’s Estate (normally over 7 years, so that after 7 years the gift/transfer is not calculated as part of the IHT equation).

This provides the opportunity for substantial gifts to be made which will not reduce the IHT liability in the short run but will do so after a 7 year period. In this 7 year period, a suitable life assurance policy could be considered, written under a trust, to insure the IHT liability through this waiting period. This would mean the IHT liability is paid by the life assurance should the donor (the person making the gift) not live for 7 years (in most cases they probably will live 7 years); but once 7 years has elapsed, the life policy stops and the gift/transfer is now outside the Estate.

Tip: Gifts should be carefully noted/recorded and the details and intentions written down. This record should be easily accessible and available to executors and/or beneficiaries.

Step Three: Use trusts

Trusts are often viewed by the uninitiated as complicated, expensive, unwieldy or 'for the rich' and are not used or avoided accordingly.

However, in reality, trusts are relatively simple devices for individuals to use and they can have a dramatic (and positive) impact on IHT liability.

For example, if you have a life assurance policy, is this positioned under a trust? No; then it is likely that the death benefit, should it ever pay out, will be assessed for IHT. A trust can be put in place so the proceeds (the life cover) are paid direct to beneficiaries with no reference to IHT. Is this complicated? No. Is it expensive? No.

Likewise, many individuals have pension plans: these plans will commonly include a death benefit in the event that the individual dies before they take the pension. This could be the fund value at the date of death being paid out.

Is this written under a trust? If the answer is no then the death benefit – which is normally paid to the spouse – will form part of the IHT equation, even if this is after the spouse has died. Very simply, a trust can be put in place so that the benefits paid out on death bypass the spouse for IHT purposes.

In both the above examples, the use of trusts is a simple, easy to implement process which is very cost effective but highly tax efficient.

In terms of more ambitious trust planning situations, there are many different circumstances and variations around how and when trusts can be used; the aim for us, here in this guide, is to describe the way that trusts can be introduced into IHT planning and to provide some examples and tips on their usage. This is an area where you have to get specialist advice if you want to consider using trusts in your plans.

At their simplest, trusts provide a legal framework around an asset or assets, which removes the ownership from the individual and places it into the hands of trustees on behalf of nominated beneficiaries. This means that an individual can take an asset and put it into a trust, taking it outside of their Estate for IHT assessment (although in many cases this may take 7 years to work because of the rules on gifts).

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Step Three: Use trusts

Trusts are extremely valuable in many ways, including beyond IHT planning. The trust may – and probably will - clarify wording around who is entitled to the Estate in the event of the individual's death which can be helpful with situations where there are second marriages and children from different marriages; trusts can help protect assets from being assessed in a bankruptcy or from long term care means testing.

Establishing trusts during your lifetime is a very important way of mitigating IHT but, in addition to being highly tax effective, they also offer other benefits. Many trusts are also used to prevent children from accessing money until a certain age or until they are capable of dealing with the funds.

Further (and increasingly important) uses of trusts are to protect assets, typically property, in the event of divorce, remarriage, bankruptcy or attack from creditors such as local authorities.

Depending on the style of trust, you can control either the capital/asset or the income generated or both.

Trusts are an integral part of IHT mitigation and there are many variations. The use of trusts is often seen as overly complex and this can be a reason why some people will be put off. However, the judicious use of trusts can achieve the optimum position of controlling the assets whilst simultaneously removing the asset from the grasp of the taxman.

The implementation and use of one or more trusts is an essential tool for managing capital and income both during lifetime, on and after death, but it does require a skilled hand; one that only a specialist can provide.

Tip: The use of trusts and putting the right trust(s) into place is one of the most specialised areas of financial planning and requires the services of an established practitioner. Please make sure anyone you use to get advice about trusts is suitably qualified in this area. There are specific trust exams and qualifications, so always check that your adviser has these before taking any advice.

Step Four: Use IHT efficient investment vehicles

This is possibly the area of IHT planning that is becoming more popular than any other, mainly due to factors such as:

- A growing awareness of the availability of such investments
- Their sheer efficiency – many of these investments achieve a complete freedom from IHT after just two years
- The fact that these investments are much more risk controlled than they were in the past and are now more 'mainstream'

Examples of investments that create IHT freedom are investments into AIM shares; EIS companies and funds*; Business Property Relief arrangements and agricultural land. Investing money into these areas and types of investment often comes with other tax advantages, such as Income Tax relief, relief or deferral against Capital Gains Tax and, in some cases, loss relief against the investment turning sour and losing your invested money.

One particularly beneficial development was the introduction of ISAs which can now include investment into AIM shares. This produces a position where individuals can – for the first time – have an ISA (if the underlying money is invested into AIM shares) which shelters the investment from IHT, after the 2 year time frame.

Typically, these IHT-efficient investment areas have a higher risk to the invested capital than the average investment; however, this may be a trade-off worth making and many investors will have high risk elements within their diversified portfolios anyway.

There are bespoke portfolios of funds available which fund managers have constructed to diversify this risk and there are many IHT-efficient portfolios, including some innovative funds which aim to provide the IHT exemptions with a high level of capital preservation.

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Step Four: Use IHT efficient investment vehicles

The benefits of using investments which provide exemptions from IHT are considerable:

- The money remains available and under your control
- There are often multiple tax benefits, not just IHT benefits
- If IHT legislation changes in the future, these are not convoluted plans to avoid IHT which are irreversible or difficult to change/adapt (as some of the more in depth trust arrangements may be)

*** Enterprise Investment Schemes (EISs) are very high-risk investments. An EIS Investment is usually concentrated in one single, unquoted trading company. Often there is no market for the shares and it may therefore be very difficult to make a disposal. There is a strong possibility of the chosen company failing.**

The value of an investment and the income from it could go down as well as up. The return at the end of the investment period is not guaranteed and you may get back less than you originally invested.

Tip: Using IHT efficient investments should always be about the 'dog wagging the tail' – not the other way round! Please make sure that the investment used suits your risk position and requirements and is not chosen solely to reduce your IHT liability.

Step Five: Use life assurance

The use of life assurance to cover an IHT liability is, strictly speaking, not a way of saving or reducing the tax bill that will eventually be payable. However, it is a way of tackling the liability where other methods, which would mitigate the tax (e.g. gifts or the use of exemptions), are deemed unfavourable or less attractive.

As an example, let us take the scenario where a couple – both in their mid-sixties – have a potential IHT liability of £600,000. The couple have no scope to make gifts or to undertake any other meaningful planning. However, they do not want their estate to be taxed to such a heavy extent.

In this example, it would be possible for the couple to consider life assurance cover, most likely to be a second death whole of life assurance policy with a sum assured of £600,000.

This policy would need to be written under a trust, to make sure that the sum assured (£600,000) is paid out free of IHT; a simple thing to do and arrange.

The sum assured pays out on the second death of the couple, which is when the IHT liability is almost certain to manifest and be payable. At this point, the policy proceeds will arrive with the beneficiaries – before Probate and without any recourse to any other delay – free of IHT and can be used to pay the tax liability, ensuring the value of the couple's estate is passed to the beneficiaries.

The common misconception many people have before they consider this as a viable option to deal with an IHT liability is that the life assurance cost will be prohibitive. However, second death life policies of this type are surprisingly cost effective.

The balance of the consideration here for many couples is around the cost of covering the liability using a life policy against the option of either making gifts, using trusts, investing in tax efficient vehicles or doing nothing. When weighed against some of the negatives that any of these alternatives may present, the life assurance option can be pleasingly simple, cost effective and efficient.

It may be that this option is pursued in conjunction with other IHT planning as opposed to a one-dimensional solution.

Tip: Life assurance solutions are sometimes seen as an 'admission of defeat' or a 'cop out' from more advanced planning; nothing could be further from the truth. Regardless of whether you end up using life cover to protect your IHT liability, it is always worth seeking out an illustration of the costs involved as this often presents a pleasant surprise.

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