

A Guide To Inheritance Tax And Tax Planning



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Introduction

In principle, the value of an individual's estate on death (together with the value of any gifts made in the previous seven years) is subject to Inheritance Tax ("IHT") at the rate of 40%.

In practice, there are a number of exemptions and reliefs from IHT which mean that, by sensible planning, IHT payable on the value of assets at death and lifetime gifts can be greatly reduced.

Advice designed to minimise IHT can be complicated and will always depend on the circumstances relevant to each individual case. For instance, it may relate specifically to lifetime gifts, gifts by Will, the creation of trusts or to a combination of all of these.

Hewitsons has a specialist department to advise on the whole range of Capital Tax planning for both business and private clients. We would therefore be pleased to advise you on your own particular circumstances and to outline some tax planning measures if appropriate.

The purpose of this Guide is to outline how IHT works, and by doing so, help you understand the tax planning advice you have been given, or simply introduce you to the tax.

Part 1: How IHT works

When Is IHT Actually Paid?

Although both lifetime gifts and the value of assets on death are subject to IHT, in the majority of cases (certainly in the case of individuals) it is only paid on the death of an individual. This is because the treatment of most lifetime gifts (other than into trusts), for IHT purposes, depends on how long the individual survives after making the gift.

Lifetime Gifts

Generally speaking, lifetime gifts are exempt from IHT if the donor survives for seven years after making them. They are therefore known as "Potentially Exempt Transfers", or "PETs". For gifts made over three years (but not over seven years) before death, the rate of IHT may be reduced, if the total value exceeds the "nil rate" band applicable at the donor's death. This is known as "taper relief" but in most cases, the

gift will simply use up the first part of the available nil rate band exemption on death.

Transfers into trusts (if in excess of the nil rate band) will attract IHT at a rate of 20% unless to a trust for a disabled person.

The amount of IHT on lifetime gifts (if any) can only be finally calculated when the donor has died. It is therefore sensible to keep a record of all gifts made (with dates) which may subsequently be subject to IHT.

The Nil Rate Band

When an individual dies the value of his or her assets is added to the value of any non-exempt lifetime gifts made in the previous seven years to calculate the total amount subject to IHT.

In the tax year 2008/2009, the first £312,000 of that total is subject to IHT but at a "nil rate" and it is therefore known as the nil rate band. The remainder of the total is subject to IHT at 40% and the tax must usually be paid before the remainder of the deceased person's estate can be distributed.

The Transferable Nil Rate Band

The pre-budget report of October 2007 introduced the transferable nil rate band (TNRB) and this is expected to receive royal assent in the summer of 2008. H.M. Revenue & Customs are processing accounts on the death of the second spouse or civil partner as if the legislation had been passed.

A claim can be made to transfer any unused IHT nil rate band on a person's death to the estate of their surviving spouse or civil partner who dies on or after midnight on the 9 October 2007. This applies where the IHT nil rate band of the first deceased spouse or civil partner was not fully used in their estate. The amount transferred is the proportion unused and at current rates.

E.g.

Husband dies in 02/03.

Nil rate band was £250,000.

£50,000 of legacies were left to non-exempt beneficiaries (children) and the remainder to the wife.

Wife dies in 08/09.
Nil rate band is £312,000.
80% of husband's nil rate band can be transferred.
Wife's estate has £312,000 + £249,600 = £561,600.

Part 2: Exemptions And Reliefs From IHT

The total of an individual's lifetime gifts and assets on death which are subject to IHT may be reduced by certain exemptions and reliefs. The main ones are:-

Lifetime Gifts Exempt From IHT

- *The first £3,000 worth of gifts made by an individual in any one tax year. If the full £3,000 allowance is not used in one year, the unused part (or the whole) may be carried forward but for one year only.*
- *Gifts of not more than £250 each may be made to any number of persons in a tax year. Any number of these gifts may be made, but if any gift exceeds £250 it will form part of the £3,000 allowance referred to in the previous paragraph and may affect other exemptions.*
- *Gifts which are regular enough to be normal expenditure out of income. However, they must be made out of income and leave sufficient to maintain the usual standard of living of the person making the gift, e.g. the payment of insurance policy premiums on another person's life (or in trust for that person).*
- *Gifts to children (£5,000 limit per gift) or grandchildren or great grandchildren (£2,500 limit per gift) on their marriage.*

Gifts Between Spouses and Civil Partners

All outright gifts between spouses and civil partners (whether during lifetime or on death) are exempt from IHT except where the donor is domiciled in the UK but the recipient is not domiciled in the UK.

It can often be advantageous to equalise estates between husbands and wives/civil partners for future flexibility of gifts. If one spouse is very much younger than the other, it makes sense for the bulk of gifts to be made by the younger.

Agricultural Property Relief

Property which is occupied for agricultural purposes may receive relief from IHT of either 100% or 50% of its value. 100% relief is generally available if the individual has the right to vacant possession of the property (or can obtain it within 12 months). However, there are qualifying periods for ownership of the property before the relief applies. In September 1995, the government relaxed the IHT treatment of tenanted land. Land subject to new tenancies after that date should qualify for 100% relief.

Business Property Relief

Certain "relevant business property" also qualifies for relief. This includes a sole trader's business, a share in a partnership, shares in certain types of company and also land, buildings, plant and machinery used in such businesses. However, investment company and land or share-dealing company holdings will not usually qualify for the relief.

The rates of relief are 100% or 50%. The 100% rate usually applies to a sole trader's business, a partnership share or a shareholding of private trading company shares. Again, there is a qualifying period of ownership (currently two years).

Other Exemptions

Other exemptions include gifts to charities, political parties and donations to certain organisations (e.g. the National Trust, British Museum etc).

Other Important Issues

Reservation Of Benefit

Although gifts made during lifetime will usually qualify as PETs, they will not do so if some benefit is reserved from the gift. For instance, an individual who gives away his home but continues to live in it until his death will be treated for inheritance tax purposes as still owning the property at his death.

Pre-owned Assets Change

Legislation introduced in Finance Act 2004 retrospectively imposes an income tax change on some assets (particularly property and chattels) given away under arrangements previously effective for reducing IHT.

Trusts

Following Finance Act 2006 the creation of a trust may be chargeable to IHT immediately at lifetime rates (currently 20%). Tax may not be due if the value of the gift is less than the nil rate band but it will count towards the total value of lifetime gifts to be calculated on the death of the person creating the trust if that person dies within seven years of establishing the trust. A trust is also subject to a periodic charge and IHT occurring on the tenth and subsequent ten-year anniversaries of the creation of the Trust. The rate is currently a maximum of 6%.

The creation of a trust for a disabled person (as defined in the legislation) will not trigger a charge. Certain pre budget 2006 trusts are also treated differently.

Other Taxes

Bear in mind that even where gifts are exempt from IHT, it may be necessary to consider other taxes such as Capital Gains Tax, Stamp Duty Land Tax or possibly VAT.

Part 3: Wills and Tax Planning

Many couples now have Wills incorporating a nil rate band discretionary trust: do they need to change these? Not necessarily, because usually the trust is drafted so that the assets can simply be given to the survivor and the transferable nil rate band of the first spouse to die is preserved.

The survivor can, of course, instead make lifetime gifts using the assets of the first to die (if circumstances allow) to reduce the IHT in their estate. This may be particularly appropriate if he or she is much younger. Where there are assets which are likely to grow in capital value very much faster than the uplift in the nil rate band (e.g. land which will be developed) it may indeed be advantageous to still use the trust on the first death.

Sometimes a life interest trust for the surviving spouse is better tax planning. This must be tailored for the specific circumstances and so professional help is always required. Some other circumstances in which trusts should be considered in Wills include the following:

- *Where there is a second or subsequent marriage/civil partnership and there are children from previous families to be provided for or to protect against claims by a future spouse if the survivor remarried*
- *To protect part of the assets from being used for long-term care fees*
- *To cover the option of passing assets which qualify for BPR or APR to the next generation or the purchase of those assets by a surviving spouse known as "double dipping" as, in effect, the relief can be used twice.*

This document is written as an outline guide only and any action should not be based solely on the information given here. Appropriate professional advice should always be taken in specific instances.

For further information please contact one of our offices:

Shakespeare House, 42 Newmarket Road,
Cambridge CB5 8EP Tel 01223 461155

Exchange House, 482 Midsummer Boulevard,
Central Milton Keynes MK9 2EA
Tel 01908 247010

7 Spencer Parade, Northampton, NN1 5AB
Tel 01604 233233

53 High Street, Saffron Walden,
Essex CB10 1AR Tel 01799 522471

www.hewitsons.com

email: enquiries@hewitsons.com

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