Inheritance tax planning boiled down

- If the value of your estate is more than £325,000 any amount above that figure will be subject to an IHT charge of 40%

- The value of your estate is the sum total of everything you own – less any allowable debts or other liabilities

- Ensure that pensions and life insurance polices are written in trust otherwise they will included in your estate

- You have to be alive to make arrangements to avoid IHT

- There's nothing to stop you spending your wealth so as to reduce the taxable value of your estate

Other than spending your wealth, there are four other courses of action you can take to avoid your estate being subject to IHT

- Give your assets away
- Transfer your assets to a trust
- Make investments
- Buy a stake in a business

Any and all the options can be exercised, but in most instances you have to survive a pre-determined number of years after making the arrangement for your assets to be fully exempt from IHT

About inheritance tax (IHT)

IHT — a tax that's waiting to pounce
Many people are wealthier than they realise when they expire. The reason being that you never really know precisely how well off you're going to be until the very end of your life — especially when you take into account the value of your home, your insurance policies, your one-year old car, your collection of ISAs and perhaps one or two long-forgotten savings accounts. In other words, the moment you pass away, is the moment when the sum total of your real worth, down to the last pound, is added up and exposed for the taxman (and others) to see.

IHT is complicated. Rules, conditions and technicalities abound. Most of the stuff that people really want to know about IHT planning isn't easily found — at least not all in one place. Information can also be incomplete, disjointed, ambiguous, or slanted to reflect the author's interests.

This guide gathers the loose ends together and explains the subject of IHT and IHT planning in the briefest and simplest of terms. It's not a head-to-toe account, but a concise and easy-to-read summary of the most significant aspects as far as the layman is concerned. For chapter and verse on IHT you need to look elsewhere – *Her Majesty's Revenue & Customs* (*HMRC*) website is possibly the best place to start.

What is IHT?
It's a wealth tax which is collected by *HMRC* when you die.

How's IHT calculated and what's the rate?
It's based on the combined value of all the assets you've amassed during your lifetime. Your car, your home, the contents of your wardrobe, garden shed, home cinema, cutlery, crockery, pots and pans, jewellery, furniture, plants, artworks — i.e., practically **anything and everything you own**.

IMPORTANT: Providing you've not drawn a penny from your pension and your insurance policies are written in trust, those assets will not form part of your estate and will not be taxed. If neither of those conditions applies, then those assets will also be taxed.

If the value of everything you own is more than £325,000 — less any permissible debts and liabilities — then 40% of every £ over that amount will be taken from your estate. If the total is less than £325,000, then you're in the clear. The tax is paid buy those who inherit your wealth or the executors of your estate: that's one of the big differences between IHT and other taxes — someone else pays it for you!

40% of the value of everything you own over and above £325,000 — less any permissible debts and liabilities — will be taken as tax. Unless you take action while you're still living.

Avoiding IHT

The easiest and possibly most enjoyable way to avoid your wealth being taxed is of course to spend it. If however you'd like to bequeath the bulk of your accumulated wealth, then you'll need to take some steps in the IHT planning department to ensure that happens. Essentially, what that entails is '**transferring' (or moving) potentially taxable assets out of your estate. In other words, you have to give up direct control or ownership of those assets. But those arrangements must be made while you're still living**. In other words, it will be too late to establish any kind of legitimate IHT tax-avoidance arrangement when you're dead and gone.

So, your tax avoidance options while you're still alive are:

1 Give your assets away (literally)
2 Transfer your assets to a trust
3. Invest your capital
4. Buy a stake in a business

All the options can be exercised and are reasonably straightforward to implement; it's the conditions attached to them that muddy the waters…

The guessing and waiting game that is IHT planning

The 'rub' as far as all four of the options are concerned is this: for assets to become fully exempt from IHT, **they must have been transferred out of your estate for a set number of years before your death**. As most people want to retain ownership and control of their assets for as long as possible, the trick is guessing at what age you should initiate those transfers. In bald terms, you're guessing how many years you have left of your life!

- **Assets given away: are immediately and fully exempt to IHT — providing the gifts are within prescribed limits**

  Any gifts you make above the prescribed limits (except between married couples and civil partners) only become fully exempt from IHT on a gradual basis and on condition that you survive for at least four years and ideally seven years

  In the first three years, the value of the gifts is subject to the full IHT charge of 40%; from year four onwards, the rate of tax reduces every year and after seven years the gifts become fully exempt from IHT

- **Transferring assets to a trust: those assets only become fully exempt from IHT providing you survive for at least seven years, if you don't they will subject to 40% IHT**

- **Making investments, or buying a stake in a business: you have to survive for at least two years, if you don't they will subject to 40% IHT**

There's no getting round any of those conditions — they're a fact of life as far as IHT planning is concerned.

Inheritance Tax Planning – Gifts

Giving away assets (full and immediate exemption from IHT)

Gifts — in the form of cash or other assets — can be made to people (spouses, relatives, friends, acquaintances etc) and to organisations either during the life of the donor or as part of a will. Providing the gifts are unconditional and are within certain limits, they will not form part of the donor's estate and will be immediately and fully exempt from IHT. Gifts above the prescribed limits, and cash gifts out of capital realised from equity release schemes, will only become fully exempt if the donor lives for seven years after making the gift.

Gifts to people

The Spouse or Civil Partner Exemption

Married couples and civil partners
Providing the person receiving the assets has their permanent home in the UK, married couples and civil partners can pass on — while still alive or on death — all their individual possessions and assets, of any value, to the surviving partner, tax-free. (As the deceased person's executors or personal representatives are obliged to transfer his or her unused nil rate band to the surviving spouse or partner, this provision does not need to be stipulated in the will.) **This exemption is known as the spouse or civil partner exemption.**

Assuming that none of the tax free allowance has been used by the first partner to die, gifting assets to a surviving partner enables the recipient to combine both tax free allowances — i.e. the surviving partner's effectively doubles to £650,000. (Gifts to an unmarried partner or a partner who is not in a registered civil partnership only become fully exempt after seven years.)

Single people
The option to transfer the tax free allowance to another party is not available to single people.

The **annual exemption allowance** enables a donor to make gifts of up to £3,000 in each tax year to **anyone** of their choosing. If the allowance, or part of it, is not used in the current tax year, it can be carried forward to the following tax year, but no further.

Wedding gifts and civil partnership ceremony gifts. Providing the gifts are made on, or shortly before the date of the wedding or the ceremony, parents can each give gifts worth up to £5,000; each grandparent and great grandparent can give up to £2,500; anyone else can give up to £1,000.

Small gifts. One cash gift of up to £250 per person can be made in any one tax year to as many people as the donor wishes, providing the recipients have not received a share of the £3,000 annual exemption allowance.

Regular gifts or payments
Regular payments made out of taxed income, for birthdays or to a financial dependent, for example, are normally exempt from IHT.

Gifts to organisations

Subject to certain conditions, gifts can be made to the following UK-based entities:

- Charities
- National institutions such as museums, universities and the National Trust
- Any political party which has at least two MPs

Giving away assets (full exemption from IHT but only after seven years have passed)
It is permissible to make gifts in excess and outside of the exemptions above, but those gifts will be treated as *Potentially Exempt Transfers* (PETs). In other words although the value of the gift may not be fully and immediately exempt from IHT it will be after a certain period of time. For a gift to be fully exempt, the donor must survive for at least seven years after making the gift: if the donor dies within the 7-year period, then IHT will be payable, albeit on a decreasing scale, at the following rates:

Taper relief on gifts
If the donor of the gift expires within three years of making it, then the gift will be deemed to be part of his or her estate and the full tax charge of 40% will apply. If however the donor dies between three and seven years after making the gift, then the tax payable reduces as follows:

- After 3 to 4 years the rate of tax is 32%

- After 4 to 5 years the rate of tax is 24%
- After 5 to 6 years the rate of tax is 16%
- After 6 to 7 years the rate of tax is 8%

From year 8, 100% tax relief applies and the gift is not subject to IHT.

That's the easy bit. Now the going gets a little more complicated. And none of these options provide immediate exemption from IHT

Your three remaining options are:

- Transfer your assets to a trust
- Invest your capital
- Buy a stake in a business

Assets which are moved out of your estate are initially <u>potentially exempt transfers</u>. In other words, those assets will only become <u>actually exempt</u> from IHT providing you survive for a period of time — either two years or seven years — after making the transfer.

Part company with your assets by putting them into trust — a potentially exempt transfer leading to full exemption after seven years

About Trusts

By assigning some or all of their assets to a trust, an individual can mitigate their potential inheritance tax (IHT) liabilities. A trust is a legal entity where one or more individuals or an organisation (the 'trustees') assume responsibility for dealing with a person's tangible or intangible assets, which can include land, shares, intellectual property rights and other types of assets such as jewellery, art and cash.

The person who assigns his or her assets to a trust is known as the 'settlor'. The settlor's assets are placed in trust on behalf of the trust's ultimate beneficiaries, which can be one or more individuals, a family, or any other defined group of people. Beneficiaries may be entitled only to a share of the trust's income, a share of the capital, or a share of both.

The trustees — who own the assets assigned to the trust on behalf of the beneficiaries — are responsible for the management of those assets and for carrying out the wishes of the settlor. The trustees (of which there are usually two) can be any individuals of the settlor's choosing including a spouse, relative, friend, lawyer or an accountant, for example.

Assets transferred to a trust (other than a Loan trust) are treated by *Her Majesty's Revenue & Customs* as being either a ***<u>potentially exempt transfer</u>*** **(PET)** or a ***<u>chargeable transfer</u>*** **(CT)**.

Where the value of the assets transferred is within the IHT tax free allowance it is a PET and no IHT will be payable on those assets — **<u>providing the settlor lives for seven years after making the transfer</u>**. Where the value of the assets transferred is above the IHT nil rate band, it is a CT and 20% IHT is immediately payable on the excess.

Transferring assets to a trust can help mitigate the bulk of the settlor's IHT liabilities but IHT is still payable in certain circumstances. In most instances, on the tenth anniversary of the trust (and every 10 years thereafter) the trustees will have to pay a charge if the value of the taxable assets held within the trust is above the IHT threshold — up to a maximum of 6%. IHT will also be payable (at the same maximum rate) when assets leave or are transferred out of a trust. Typical instances of transfers are when the trust arrangement terminates, or some or all of the trust's assets are distributed to beneficiaries.

There are many different types of trusts, some of the more common ones being:

Bare trust: the assets held within the trust belong to a named beneficiary not the settlor – an irrevocable arrangement. The trustees have no say in the distribution of assets.
Discretionary trust: the trustees decide which beneficiaries (which do not have to be named at the outset) should receive a share of the capital held within the trust and any income it produces, how much they receive, and when they receive it.
Spousal Bypass Trust: arranging for moving an 'untouched' pension and/or the proceeds from any life insurance and mortgage protection policies into a SBT on death ensures that those assets do not form part of your surviving spouse/partner's estate and therefore will not be subject to IHT when he or she dies.

Interest in possession trust: if a settlor owned income-producing shares and wanted to ensure that his or her spouse was able to continue to draw income from these shares, the settlor would name the spouse as the trust's beneficiary.

Inheritance Tax Planning – Qualifying Investments

Making a qualifying investment (full exemption from IHT after two years)

Enterprise Investment Schemes (EIS)
Under the EIS, which is a government scheme, 'qualifying' investors holding 'qualifying' shares in 'qualifying' companies may be eligible for a range of tax concessions. The rules governing what exactly constitutes a qualifying investor, share and company are strictly defined, although the main points can be summarised as follows:

- A qualifying investor is an individual who has no connection with the company
- Qualifying shares are new ordinary shares which are issued for legitimate commercial reasons and assign no preferential rights to dividends or assets to the shareholder should the company go into liquidation
- Qualifying companies need not be resident in the UK for tax purposes but must be unquoted (companies listed on *AIM* - the *Alternative Investment Market* - are considered unquoted). The funds raised have to be used by the company to help the enterprise carry out its 'qualifying' activities, which encompass most forms of trade except for certain prohibited businesses. The company cannot have more than a certain number of employees and its gross assets (including any subsidiaries) must not exceed certain limits prior to, and post, investment.

As well as offering investors capital gains tax deferral relief and income tax relief, **qualifying EISs are also IHT exempt** on condition that the investment has been held for a minimum of two years prior to the investor's date of death.

Buying shares listed on the Alternative Investment Market (AIM)
Companies listed on the AIM are usually relatively small enterprises compared to those listed on the *London Stock Exchange's Main Market*. Because qualifying AIM shares are deemed by *Her Majesty's Revenue & Customs* to be a business property — and providing they're held for at least two years — the holding (or holdings) are eligible for 'Business Property Relief' (BPR) at 100% and will not form part of the investor's estate when he or she dies. A 'qualifying' AIM investment is a trading company which conducts most of its business in the UK. None qualifying businesses are those trading in land or securities, or receiving substantial income from letting property or land. Companies that are listed on another recognised stock exchange also do not qualify.

Inheritance Tax Planning — Buying a stake in a qualifying business

Buying a stake in a qualifying business (full exemption from IHT after two years)

Business Property Relief (BPR)
Owners of businesses are not required to pay inheritance tax on the assets of the business when ownership of those assets is passed on ('transferred') elsewhere. Providing the business, or some other asset or assets of the business, qualifies as a 'relevant business property' and the transferor of the property has owned it for at least two years, then BPR – which reduces the value of the property for IHT purposes by either 50% or 100% - can be claimed. (BPR applies to business interests worldwide, not just the UK.)

The following constitute relevant business properties:

- A business, or an interest in a business, such as a partner in a partnership (on condition that the enterprise is in business to make a profit and is not engaged, wholly or mainly, in the buying and selling of shares, securities, land or buildings)
- Shares held in unquoted companies including shares traded in the *Unlisted Securities Market* (USM) the *Alternative Investment Market* (AIM) and *Enterprise Investment Schemes*, providing those shares are not listed on a recognised overseas stock exchange
- Shares in a business which is listed on any recognised stock exchange, where the transferor holds more than 50% of the voting shares – i.e., the transferor has control of the business
- Where a partner or controlling shareholder owns assets that the business uses such as land, buildings, plant or machinery etc., as long as those assets are not for the personal use of the transferor of their family