

LEONARD GRAY SOLICITORS

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Wills, Tax and Estates Department

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# A Guide to Inheritance Tax Planning and Solutions

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These notes are intended to be a general overview of the law in relation to the subject detailed above.

Legal advice on the issues and the application to a particular case should still be obtained.

This constitutes our understanding of the law as at April 2008.

## Basis of Taxation

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**THIS SECTION**

- How IHT works
  - Further advice
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*What is Inheritance Tax and how does it effect me?*

Inheritance Tax (“IHT”) and more particularly, how to avoid it, is a topic often found in the national press at the current time. It used to be a tax which afflicted only the very rich and wealthy but today a very different situation is in place.

Because of the rise in the houses and land over recent years, almost anyone in the south east of England (and indeed many other areas) with a modestly sized house could find their estate will pay at least some Inheritance Tax.

Changes brought about in the Pre-Budget report announced 9th October 2007 have improved the situation for many married couples and those in Civil Partnerships. The changes come into effect immediately.

### The Tax

#### 1. How it works

With respect to Inheritance Tax, currently the first £325,000 of a person’s estate passes tax-free on death and any sum above this nil rate band is taxed at a rate of 40%. This tax only applies when your children or other non-exempt beneficiaries inherit your estate. A spouse or charity inheriting is not liable to pay any tax. The methods open to you to reduce the inheritance tax eventually payable are set out below.

#### 2. Further advice

Having read this guide, if you would like any further advice please do not hesitate to contact Clive Burrell (email: [cburrell@leonardgray.co.uk](mailto:cburrell@leonardgray.co.uk)) or Chris Kelly (email: [ckelly@leonardgray.co.uk](mailto:ckelly@leonardgray.co.uk)) of our office. They can be contacted on 01245 504904.

## The new position for Spouses and Civil Partners

### THIS SECTION

- The Spouse Exemption
- The old law
- The new law
- Examples
- Nil rate band discretionary trusts

*The Pre-Budget Report announced on 9<sup>th</sup> October 2007 has brought about significant changes for spouses and civil partners in relation to Inheritance Tax.*

Spouses and Civil Partners have always been able to take advantage of the “spouse exemption” for Inheritance Tax purposes. This means that they can leave to their surviving spouse/partner any amount of value on death with no charge to Inheritance Tax.

### The spouse exemption

So regardless of whether a husband’s estate is worth £5 or £5 million, he would be able to leave this to his wife with no Inheritance Tax to pay. And of course the same applies in relation to wives and civil partners.

### The old law

The problem that existed prior to 9<sup>th</sup> October 2007 was that on the survivor’s death, they would have the one large estate in their sole name against which only one nil rate band (of currently £325,000) would apply.

This led many couples to seek to use Nil Rate Band Discretionary Trusts in their Wills, to try to make use of the first deceased’s nil rate band in the form of a deductible debt on the second death.

### The new law

The new law, which came into effect immediately, states that where the second death of a married couple/civil partnership occurs after on or 9<sup>th</sup> October 2007, any unused proportion of the nil rate band available on the first death can be transferred to the second estate. It even applies where the first death occurred prior to 9<sup>th</sup> October 2007.

In many cases this will mean there will be two nil rate bands available on the second death.

Any gifts to non-exempt beneficiaries made on the first death will be deducted as a proportion from the transferred nil rate band. The following two examples give further information:

**Example 1**

Mr Jones dies in 2004 leaving an estate worth £400,000 to his wife in entirety using the spouse exemption. Mrs Jones dies in late 2007 leaving a total estate worth £650,000. 100% of the nil rate band available at her date of death can be transferred from her late husband's estate to be aggregated with her own nil rate band. This means there would be two nil rate bands of £325,000 totaling £650,000. As such, no Inheritance Tax would be paid.

**Example 2**

Mrs Smith dies in late 2002. The nil rate band applicable to her estate would have been £250,000. She leaves £50,000 to her children in equal shares and the rest of her estate to her husband under the spouse exemption. 20% of her nil rate band has been used (ie, £50,000 as a percentage of £250,000) so 80% of the nil rate band can be transferred to her husband.

Mr Smith then dies in December 2009 leaving an estate of £700,000 in total. His own nil rate band is £325,000. 80% of his late wife's nil rate band is available to transfer meaning the total nil rate bands to offset his estate would be £585,000. As such the balance would be taxed at 40% meaning an Inheritance Tax liability of £46,000.

It is important to bear in mind that if a married couple divorce or a civil partnership is dissolved the transferability of a nil rate band then ceases.

It can be seen that even where the new applies giving two nil rate bands on the second death there may still be a liability to Inheritance Tax unless other measures are taken.

**What about nil rate band discretionary trusts – should they still be used in Wills?**

The simple answer to this is “no”. These were previously seen as tax efficient but this is no longer the case. The position under the new law has several advantages over the nil rate band scheme as follows:

1. The potential Inheritance Tax saving is greater. If a husband died leaving his estate outright to his wife in 2008 and then his wife died in 2010 (post 5th April) there would be two nil rate bands of £350K to offset against her estate, ie, total £700K.

If the NRB scheme was used in the same circumstances, the IHT saving would be smaller. Although the wife's nil rate band would still be £350K, the capital debt to be deducted from her estate would be fixed with reference to her husband's nil rate band in 2008. This earlier nil rate band would be £312K making the total saving £662K.

2. The costs of securing the IHT saving during the first and second estate administrations will be greatly reduced using the new law.

3. Any risks associated with the NRB scheme being attacked in the future by the Revenue and case law is eliminated.

As such, our advice to any clients who have the nil rate band discretionary trust scheme in their wills is to arrange for it to be removed.

**My spouse/civil partner has already died leaving a nil rate band discretionary trust created by their Will. Can this be concluded so that I can use the new position at law?**

Unfortunately, at the present time we are not aware of a method for doing this. The government have not legislated for this situation. The difficulty is that in most cases the majority if not all of the nil rate band will have been used on the first death and as such cannot be transferred to the surviving spouse.

As such, the trust would probably have to be perpetuated so as to obtain the Inheritance Tax saving eventually.

**THIS SECTION**

- Annual Allowances
- Marriage gifts
- Small gifts
- PETs
- IHT Bonds
- Policies/Pensions
- Surplus Income

## Mitigating IHT during your lifetime

*It is possible to take steps to reduce an Inheritance Tax liability during your lifetime.*

There are a number of steps that you can take which can assist in reducing an Inheritance Tax bill and if implemented regularly and over a long period of time could have quite an effect

### Steps you could take during your lifetime

#### 1. Annual Allowance for gifts

You could look at using life-time gifts to your children and/or other relatives. Each individual can make a gift of £3,000 per annum during their life-time and this would be completely exempt from any tax.

#### 2. Marriage gifts

A sum of £5,000 can be given to a child on marriage and the sum of £2,500 can be given to a grandchild on marriage tax free in any tax year.

#### 3. Small gifts to individuals

Any number of small gifts of £250 per recipient per tax year can be made, as long as these are not regular in nature and do not affect your own standard of living.

#### 4. Potentially Exempt Transfers (PETs)

Larger gifts can be made and would also be tax-free, provided you survived for seven years from the date of the gift. In giving away an amount during your lifetime that exceeds the annual allowance you create a Potentially Exempt Transfer (PET). In the event that an individual has not used their allowance from the previous tax year, then they would be able to gift a total of £6,000.

Tapering relief is available where a gift is made in excess of the nil rate band available at the date of the gift and the transferor survives for longer than 3 years. Any amount up to the value of the nil rate band (assuming no other gifts had been made in the 7 years prior to the gift) would be deemed to “eat into” the transferor’s nil rate band. Any amount over the value of the nil rate band would be subject to tapering relief as is described in the following table.

<b>Years between gift and death</b>	<b>Percentage of tax payable</b>
0 to 3	100%
3 to 4	80%
4 to 5	60%
5 to 6	40%
6 to 7	20%
More than 7	Nil

#### **5. Example of tapering relief**

Mr Bloggs gives his son £400,000 in September 2004. He makes no other gifts and then dies in December 2009. The nil rate band at his date of death is £325,000. He has survived 5 to 6 years since the date of the gift. Ignoring his own estate, there will be tax charged at 20% of the usual rate (40%) on the value of gift above his nil rate band.

The tax will therefore be calculated as follows:

$$20\% \times 40\% \times £75,000 = £6,000.$$

#### Note re Capital Gains Tax (CGT)

If you are considering giving away property or assets other than cash or your interest in your own home there is a possibility that a charge to Capital Gains Tax may arise. Accountancy advice should be sought if in doubt.

#### **6. Inheritance Tax Bonds**

It is possible to purchase insurance policies/bonds to meet part or all of inheritance tax liability. Although Leonard Gray cannot provide financial advice direct we can offer assistance in reviewing your financial investments and inheritance tax liability through our link with local Independent Financial Advisers with a free, no-obligation interview.

**7. Life policies/pension schemes**

If you ensure that life policies or pension schemes are written in trust for your spouse or children this will mean that the monies due will not form part of your estate and as such cannot be taxed. Bear in mind, however, that if they are written in trust now you may create a PET and as such would need to survive for 7 years for the writing into trust to be free of IHT.

**8. Surplus income**

If you regularly, year upon year, have an underlying income surplus to your requirements, this can be gifted to a person or persons of your choice tax-free. There needs to be a settled pattern of gifting, backed up by documentation evidencing that intention. Any gap years, where no gifts are made, may render these types of gifts taxable.

## Mitigating IHT on death

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**THIS SECTION**

- Old schemes
  - Gifts to charity
  - Deeds of Variation
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*Following on from the measures which could be taken during your lifetime, we look in this section at the options available on someone's death to reduce Inheritance Tax.*

Prior to 9<sup>th</sup> October 2007, drafting Inheritance Tax efficient schemes within Wills for a married couple or civil partners was very common and allowed a great saving in Inheritance Tax. Since that date, with the new position at law explained in section 2, this is no longer necessary

### **Nil rate band discretionary trusts and gifts to children on the first death**

These options are no longer considered necessary or viable for the reasons given in section 2.

### **Gifts to spouses**

This is covered in section 2.

### **Gifts to charity**

All gifts to charity are free of Inheritance Tax. As such, if an individual chose to leave all amounts in excess of their nil rate band to charities of their choice, there would be no Inheritance Tax to pay on their estate.

### **Deed of Variation**

If someone dies and their estate passes to individuals who do not wish to receive assets from the estate and perhaps wish to pass them to others, a Deed of Variation may prove useful. A Deed of Variation can be executed by a beneficiary of an estate within 2 years of the deceased's death. Such a Deed can state that although the beneficiary is entitled to assets from the deceased's estate, they are going to decline to accept some or all of these assets and these assets are to be redirected onto other beneficiaries such as children or grandchildren, for example. A Deed of Variation operates to use the nil rate band allowance of the deceased and is not treated as a "PET" (see section 3 of these notes).