

A Guide to

Inheritance Tax Planning and Solutions

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- Understand the basis for Inheritance Tax calculations.
- Understand how to reduce your Inheritance Tax liability.
- Understand your allowances for Inheritance Tax.

This Guide has been designed to assist you with some of the general issues and to answer questions that you may have. This Guide is only intended to be a general overview of the law in relation to Inheritance Tax. Legal advice should always be obtained from Leonard Gray in application to a particular case.

Section

1

Inheritance Tax

This Section of the Guide sets out the basis for Inheritance Taxation and the charge to an estate.

1. What Is Inheritance Tax?

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 house prices 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 IHT.

Changes brought about in the Finance Act 2008 and, more recently, the Finance Act 2016 have improved the situation for many married couples and those in Civil Partnerships as well as those wishing to leave their homes to direct descendants. These changes will be detailed in the next Sections.

2. How It Works

With respect to IHT, 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%.

There is a limited exception where there is an unused allowance of IHT left over from the first spouse's death to be transferred and used in the second spouse's estate but this will be considered further in Section 2.

There is also an additional "residential nil rate band" of £100,000 (increasing to £175,000 by 2020) which now applies in estates where, broadly, a home being left to children/grandchildren takes place. As with the nil rate band this can also be transferred between spouses and used on the second spouse's death. This will be considered further in Section 3.

Payment of IHT only applies when your children or other non-exempt beneficiaries inherit your estate and the estate value is in excess of both your nil rate band allowance and, regarding your property, the residential nil rate band.

A spouse or charity inheriting is not liable to pay any IHT.

The next Section of this Guide explores the situation for IHT and spouses following the Finance Act 2008.

Section 2

Finance Act 2008 – The IHT Allowance for Spouses and Civil Partners

This Section of the Guide considers the Finance Act 2008 which 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 IHT purposes. This means that they can leave to their surviving spouse/partner any amount of value on death with no charge to IHT. So regardless of whether a husband’s estate is worth £5 or £5million, he would be able to leave this to his wife with no IHT to pay. And of course the same applies in relation to wives and civil partners.

1. The Law: Pre-Finance Act 2008

The problem that existed prior to the Finance Act 2008 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 full nil rate band in the form of a deductible debt on the second death.

2. The Law: Post-Finance Act 2008

The law, which came into effect under the Finance Act 2008, states that where the second death of a Spouse or Civil Partnership occurs after 9th 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 9th 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 died in 2004 leaving an estate worth £400,000 to his wife in entirety using the spouse exemption. Mrs Jones dies in 2012 leaving a total estate worth £600,000.

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 totalling £650,000. As such, no IHT would be paid.

- Example 2

Mrs Smith dies in late 2003. 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 (i.e. £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 2012 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 (i.e. 80% of £325,000 equalling £260,000) meaning the total nil rate bands available to offset his estate would be £585,000. As such the balance, over and above £585,000 would be taxed at 40% resulting in a IHT 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 this rule applies giving two nil rate bands on the second death there may still be a liability to IHT unless other measures are taken.

3. Nil Rate Band Discretionary Trusts – Should They Still Be Used in New 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:

- The potential IHT saving is greater. If a husband died leaving his estate outright to his wife in 2008 and then his wife died in 2010 there would be two nil rate bands of £325K to offset against her estate, totalling £650,000. 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 £325K, 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 £637,000.
- The costs of securing the IHT saving during the first and second estate administrations will be greatly reduced using the new law.
- Any risks associated with the NRB scheme being attacked in the future by HMRC 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.

4. Existing Nil Rate Band Discretionary Trusts in Place – Can They Be Concluded Now?

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 IHT saving eventually.

The next Section of this Guide explores the residential nil rate band following the Finance Act 2016.

Section 3

Finance Act 2016 – The Introduction of the Residential Nil Rate Band

This Section of the Guide considers the Finance Act 2016 which brought about an additional Inheritance Tax allowance to be applied if the individual and estate meet the qualifying conditions.

The new residential nil rate band (“RNRB”) for IHT purposes came into effect in April 2017. It is important to remember that whilst the nil rate band detailed in the previous Section can be applied to any assets, the residence nil rate band can only be applied against one property in which the individual has lived in during their lifetime and is either owned at death or was sold after the 8th July 2015.

1. Who is Entitled to the RNRB?

The RNRB applies to deaths on or after 6th April 2017 where the individual has a “qualifying residential interest” which is to be “closely inherited”.

A “qualifying residential interest” is an interest in a dwelling which has been the deceased’s residence at some time during their ownership. This interest is limited to one residential property. It is therefore down to your personal representatives to nominate which residential property should qualify if there is more than one in the estate.

To be “closely inherited”, the qualifying residential interest must either pass to a lineal descendant outright or on certain types of trusts. A lineal descendant will be a child (including a step-child, adopted child or foster child) of the deceased and their lineal descendants, including their spouses. A child of a cohabitee is not a step-child for these purposes.



2. What is the IHT Allowance Under the RNRB?

The RNRB was introduced from 6th April 2017 at an allowance of £100,000 and will increase as follows:-

2017/2018	£100,000
2018/2019	£125,000
2019/2020	£150,000
2020/2021	£175,000
2021/2022 onwards	Increase in line with the Consumer Prices Index

NOTE: If the value of a person's net estate exceeds £2m the RNRB is reduced at a rate of £1 for every £2 above the £2 million threshold.

3. Transferring the RNRB

Where a person dies and their estate has not had the benefit of the RNRB then any unused RNRB can be transferred to the deceased's spouse or civil partner's estate. This even includes when the first spouse died before 6th April 2017, even though the RNRB wasn't available at that time. This is irrespective of how long ago the death occurred, what the deceased owned and who inherited the estate at that time.

- Example:

Mr and Mrs Smith were married. On Mr Smith's death in 2010, he leaves his share of the matrimonial home, together with the remainder of his estate to his wife. Mrs Smith later dies in November 2018.

On Mrs Smith's death the value of the matrimonial home is £300,000 and her remaining estate is worth £600,000. Mrs Smith's Will provides for all assets to be divided equally between her two children. Mrs Smith has not made any lifetime gifts.

In this example, the first £250,000 of the value of the home is covered by the combination of Mrs Smith's RNRB (£125,000 in 2018/2019) and the transferred allowance of Mr Smith of £125,000 as the property is passing to the children.

The remaining estate is made up of the remaining £50,000 value of the property and £600,000 of other assets and investments. The value of the remaining estate is then covered by the combined IHT nil rate band being £325,000 of Mrs Smith's own IHT allowance and the unused transferable nil rate band of £325,000 from Mr Smith's estate, totalling £650,000.

Had the remaining estate exceeded £650,000 then the IHT would have been payable at 40% for everything above the thresholds.

4. When is the RNRB Not Available?

Some examples are where the RNRB will not be available include:

- Individuals without children or other lineal descendants or those who are cohabiting. For instance, leaving a property to a sibling or nieces/nephews will not qualify.
- Individuals who rent their home and have chosen to invest their money, for example into an investment portfolio / buy-to-let properties.
- Individuals leaving their estate, including a property, upon the terms of a Discretionary Trust, even if all of the potential beneficiaries are lineal descendants.
- Individuals leaving a property to grandchildren under a typical grandparent settlement such as "to such of my grandchildren as shall attain the age of 21" as this is not a relevant property trust.

5. What if I Downsize and Sell My Property During My Lifetime?

It is possible to claim the RNRB in full where the deceased had either downsized to a less valuable residence or sold their residence on or after 8th July 2015, providing that:

- The property disposed of was owned by the individual and it would have qualified for the RNRB had the individual retained it; and
- The replacement property and/or assets form part of the estate which pass to lineal descendants.

There is no time limit on the period between the disposal and when death occurs.

- Example:

Mr Jones is a widower with an adult son. His wife died in 2014. He sold his home in August 2015 for £250,000 and moved into a rented, warden-assisted flat. Mr Jones later passed away in January 2019 leaving his estate to his son.

Even though at the time of his death Mr Jones no longer owned a property, his estate can benefit from the RNRB (£125,000 in 2018/2019) and his personal representatives can also carry forward his late wife's unused RNRB (also £125,000) against the value of the property which was sold in 2015.

The next Section of this Guide reviews possible IHT liability reduction methods to be undertaken during your lifetime.

**Section
4**

Reducing Your Liability to IHT During Your Lifetime

This Section of the Guide reviews the possible steps to be taken to reduce an IHT liability during your lifetime.

There are a number of steps that you can take which can assist in reducing an IHT bill and if implemented regularly and over a long period of time could be effective. Records should always be kept to confirm your actions and intentions regarding any tax planning measure.

1. Annual Allowance for Gifts

You could look at using lifetime gifts to your children and/or other relatives. Each individual can make a gift of £3,000 per annum during their lifetime 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

Larger gifts can be made and would also be tax-free, provided you survived for a period of 7 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 (i.e. two amounts of the £3,000 annual allowance).

Tapering relief is available where a gift is made in excess of the nil rate band available at the date of the gift (currently £325,000) 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.

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

- Example

Mr Smith gives his son £400,000 in September 2006. He makes no other gifts and then dies in December 2011. 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 IHT will therefore be calculated as follows:

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

Note: Regarding 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 CGT may arise. Accountancy advice should be sought if in doubt.

5. IHT Bonds

It is possible to purchase insurance policies/bonds to meet part or all of IHT 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.

6. 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.

7. 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.

The next Section of this Guide reviews methods of reducing IHT liability on your death.

Section 5

Reducing Your Liability to IHT on Death

This Section of the Guide follows on from the measures which could be taken during your lifetime and reviews two further options available on someone's death to reduce IHT, in addition to those already discussed in this Guide.

1. Gifts to Charity

All gifts to charity are free of IHT. 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 IHT to pay on their estate.

2. 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.

The next Section of this Guide will look at how to make an appointment.

Section 6

Making an Appointment

If you would like to discuss the issues raised in this Guide further then please contact a member of our team: **Chris Kelly**, **Jenna James** or **Sigourney Rutkowski** who will be happy to do so.

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We are based in Chelmsford town centre, a two minute walk from Chelmsford Rail Station with car parking and disabled access at the rear of our office for the use of clients.

Open Monday to Friday, 9am to 5pm. Alternative times by arrangement.

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