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Inheritance Tax Planning - new horizons

This Briefing considers two recent developments which potentially affect the inheritance tax (IHT) planning of many individuals. The first is the introduction of the 'residence nil rate band' in April 2017 which may enable a family home to be passed on tax free on death and the second examines the changes introduced for inherited pension funds from April 2015.

IHT and the residence nil rate band

At present, IHT is charged at 40% on the 'estate' of an individual in excess of the IHT nil rate band of £325,000. Married couples and registered civil partners (referred to throughout this Briefing as spouses) can pass any unused nil rate band on death, to one another.

An estate includes both the value of chargeable assets held at death plus the value of any chargeable lifetime gifts made within seven years of death (though there may be a discount on the 40% tax for certain life gifts). The chargeable value of assets and gifts is the value after deducting any liabilities, reliefs and exemptions that apply.

From 6th April 2017, an additional nil rate band is introduced for each individual to enable a 'family home' to be passed wholly or partially tax free on death to direct

descendants such as a child or grandchild. A step-child, adopted child or fostered child is regarded as a direct descendant. The 'residence nil rate band' (RNRB) will initially be £100,000 in 2017/18, rising to £125,000 in 2018/19, £150,000 in 2019/20, and £175,000 in 2020/21. It is then set to increase in line with the Consumer Price Index from 2021/22 onwards. The additional band can only be used in respect of one residential property which does not have to be the main family home but must at some point have been a residence of the deceased. Restrictions apply where estates are in excess of £2 million which is considered later.

When does a transfer qualify?

It should be noted that transfers made during lifetime to individuals or trusts cannot generally benefit from the RNRB unless the value of the property is still included in the deceased's estate due to it being 'a gift with reservation'. This is where the home has been legally gifted but the donor still benefits from the property such as living in the property tax free. Transfers into a trust on death cannot benefit unless a direct descendant has a specific type of interest in the trust known as an immediate post-death interest or disabled person's interest.

Effect of the new reliefs on spouses

Each individual has a main nil rate band and a RNRB. This means that up to £1 million of a married couple's estate could be taken

of inheritance tax if the full nil rate bands (£325,000 + £175,000 x 2) are available to each spouse. Any unused nil rate band may be transferred to a surviving spouse or civil partner. The amount transferred is expressed as a percentage of the amount unused at the first death. For example if on the death of the first spouse 50% of either the main nil rate band or the RNRB was unused then the estate of the second spouse would have 150% (own plus 50% from spouse) at the rates existing at the second spouse's death. It is possible where a remarriage occurs to inherit unused portions of a RNRB from more than one previous spouse but a person cannot claim more than their own plus 100% in total of the RNRB of other spouses.

Example

Robert dies in July 2017. His share in the family home is valued at £90,000 which he leaves to his daughter. The rest of his estate passes to his spouse Janet. Janet dies in 2020/21 with an estate worth £750,000 including her share in the family home worth £130,000. Her estate is inherited by her children. No lifetime gifts were made by either spouse.

On Robert's death £100,000 of RNRB is available of which £90,000 is used (90%) leaving 10% available to carry forward to Janet. On Janet's death the RNRB is now worth £175,000. Janet's estate will be able to claim a RNRB of £192,500 (100% + 10% x £175,000) representing her own RNRB and 10% from Robert. As her share in the property is worth less than this, the claim is limited to £130,000.



Death of spouse before 6 April 2017

The RNRB does not commence until 6 April 2017. Where a person dies before then, their estate will not qualify for the relief. For spouses the rules are modified. Where the first spouse's death occurs at any time before 6 April 2017, a default amount of £100,000 is deemed to be available for carry forward to a person who was their spouse at that time. This will then be uplifted for use by the second spouse on their death as demonstrated above.

The impact of a high value estate

If the net value of a death estate (after deducting liabilities but before reliefs and exemptions) is over £2 million, the RNRB is reduced by £1 for every £2 that the amount exceeds the £2 million taper threshold. For 2017/18, the first year of operation, this means that a person with an estate of more than £2.2 million will not benefit. By 2020/21 the limit will be £2.35 million. For spouses it applies on each death estate calculation. This reduction only applies where the estate at death exceeds the limit. It does not include lifetime transfers within seven years of death.

Claiming the relief

Broadly, a claim must be made by the person's personal representatives within two years from the end of the month in which the person dies or, if later, three months beginning with the date on which the personal representatives first act. Other people may claim within extended time limits.

A claim can be withdrawn within one month of whichever of those time limits applies.

The proposed 'downsizing' relief

The provisions above passed through Parliament in 2015. It is also proposed that the RNRB will be available when a person downsizes or ceases to own a home on or after 8 July 2015 where assets of an equivalent value, up to the value of the RNRB, are passed on death to direct descendants. This element will be included in Finance Bill 2016. A number of situations are envisaged including situations where the home has been gifted or sold prior to death.

Example

A widower sells his home worth £400,000 and gifts the cash to his children in May 2020. He moves into rented 'later living' accommodation. His available RNRB is £350,000 (as he has inherited £175,000 from his spouse). He has potentially lost the chance to use £350,000 which could have applied had he not sold his home.

When he dies in February 2021, within 7 years of the gift, his estate is worth £600,000 and is split between his four children. As there is no qualifying residence in his estate, it cannot use RNRB directly. But the estate is still eligible for £350,000 of RNRB.

Changes to tax charges on pension funds on death

Pensions are typically held in trust outside of the IHT estate and are therefore free of IHT in most cases. However, punitive income tax charges of up to 55% were applied for those aged 75 and over. Recent changes to the tax treatment of death benefits from pension schemes mean that there are greater opportunities to pass on pension funds tax free to any nominated beneficiary.

Death before age 75

Where the pension holder dies under the age of 75 the fund can pass IHT free to nominated beneficiaries. A nominated beneficiary is not restricted to spouses or dependants. Beneficiaries are then able to take lump sums or income withdrawals from the fund completely free of income tax. Beneficiaries do not have to wait until they are 55 to enjoy tax free withdrawals from the deceased's pension fund. Alternatively beneficiaries could 'pass on' the funds to their beneficiaries if they so wish.

Example – part 1

Andrew is 68 when he dies with a pension fund in flexi-access drawdown. He leaves the pension fund to Susan his 77 year old sister. As Andrew was under 75 when he died, Susan can take a tax free lump sum or draw tax free income.

It is a requirement for the tax free treatment (whether for lump sum payments or income withdrawals) that the beneficiary or beneficiaries are designated within two years of the death of the individual otherwise, any lump sum payments made after the two years will be taxed at 45%.

Death age 75 and over

Where the pension holder dies over the age of 75 the fund can pass IHT free to

nominated beneficiaries. The beneficiary is then able to take a lump sum or regular income withdrawals from the fund but both will be subject to income tax. If the lump sum is taken prior to 6 April 2016 it will be taxed at 45%. All other withdrawals are subject to the beneficiary's marginal rate of tax.

Example – part 2

When Susan from the previous example dies she leaves the fund to her son Frank. As Susan was over 75 on her death, Frank can take a taxable lump sum or can draw taxable income from the fund.

Frank only accesses a small part of the fund and leaves the balance to his daughter Amy when he dies at 74. Amy can draw a tax free lump sum or tax free income as Frank was under 75 when he died.

Watch the lifetime allowance

Pension fund savings in excess of a lifetime allowance are still taxed at the 55% tax if taken as a lump sum so one goal with estate planning is to ensure that this balance is not breached. The limit is currently £1.25 million but this reduces to £1 million from 6 April 2016. Please talk to us or your pension adviser about planning opportunities which may exist to protect you from the reduction in this limit.

Impact of changes on IHT planning

One key effect of the above developments is altering the way in which individuals might approach their IHT planning. Some may wish to leave pension funds intact to give to their heirs while they live on other, potentially taxable assets for example ISA accounts and investments. This will require planning to retain appropriate levels of income as well as minimizing capital held above any available nil rate bands.

Example

David and Leona have a large buy to let investment portfolio and are comfortable in retirement. As the couple do not need to use the pension fund for income David has decided to nominate his son Anthony as sole beneficiary of his pension fund. Chris dies at 73 and Anthony inherits his father's pension fund tax free.

In conclusion, you may want to contact us for a review of your IHT position as a result of the changes covered in this Briefing. In addition all existing wills may need to be reconsidered in the light of these changes.

