Keeping the lid on Inheritance Tax

Inheritance Tax (IHT) is payable at 40% on all estates in excess of £325,000. Therefore a married couple have a combined benefit of £650,000 before IHT is payable. Effective Will planning can also contribute towards minimising IHT but real planning opportunities exist for those who are prepared to consider making gifts of assets in their lifetime.

The importance of considering this issue is as a result of measures announced in the March 2010 Budget. The IHT nil rate band will be frozen at £325,000 until at least the 2014/15 tax year. This means that without any lifetime giving and even only a modest increase in values, the IHT on an estate is likely to increase over that period.

Example

An estate currently valued at £1m will pay IHT of £270,000.

If that estate grows at 5% per annum over the period up to and including 2014/15, the IHT payable on death in that year will be £356,202 – an increase of £86,202 or 32% on the current tax bill.

Take full advantage of exemptions

Each individual has an annual exemption of £3,000 for IHT. Wherever possible gifts should be made each year to the full amount of the allowance but if you miss a year you can use both the current and the immediately preceding year's allowance making £6,000 in total.

Used consistently over a lifetime, this can save a significant amount of IHT. Each allowance is worth £1,200 in tax terms so using the allowance for 30 years will save £36,000 in tax.

If you do not need the income – give it away

Where an individual has recurring excess income, this increases the value of your estate and the IHT problem. However, there is an important exemption from IHT for giving away surplus income. Referred to as the 'normal expenditure out of income' exemption, it depends on setting up a regular pattern of giving away excess income. So if this applies to you, give careful thought to setting up regular gifts to children or grandchildren for example. The sooner you do this then the easier it is to establish a pattern of normality.

A PET is not just for Christmas!

Gifts made to another individual are referred to as Potentially Exempt Transfers or PETs. A PET is assumed to be an exempt transfer at any time between the making of the gift and either the seventh anniversary of that date or the death of the transferor. If seven years elapse after the date of the gift then the transfer is definitely exempt.

If a PET becomes chargeable because the transferor dies within the seven year period, then the IHT charge is calculated by reference to the value transferred (not its value at the date of death) and the tax charge calculated by reference to the rate applicable for the year of death with a reduction of the tax being given as follows:

- transfer made between three and four years of death 20%
- transfer made between four and five years of death 40%
- transfer made between five and six years of death 60%
- transfer made between six and seven years of death 80%.

The primary liability to pay any tax on a PET that becomes chargeable rests with the recipient although the estate of the deceased may become liable by default.

PETs freeze value

The real benefit of a PET is that it freezes the value of the gift. Even if the seven year period is not reached, there is the certainty that any increase in the value of the asset will escape IHT. Elderly people should never dismiss the idea of making PETs on the grounds that they are unlikely to survive for the full seven years. There is a strong likelihood that a tax saving will result from any lifetime gift.

Example

In 2010 John (aged 90) made a gift of a property worth £200,000 to his son. John died in 2013 by which time the value of the property had increased to £300,000. The effect of the PET is to effectively save IHT on the increase of £100,000 – a potential saving of £40,000.

The sooner you start the greater the benefits

A PET remains potentially liable to IHT for seven years and if the donor died within that period the PET would use up some or all of their available nil rate band. However, once that seven year period has elapsed the PET is exempt and the nil rate band is effectively released. There can be a significant advantage in making gifts every seven years and the sooner this pattern is established the greater the opportunity.

Identify surplus assets to give away

The aim should be to identify genuinely surplus assets which are going to remain as such for the foreseeable future. If such assets generate income which is not really required, the starting point could be to consider gifting the income under the normal expenditure out of income rules. If, however, the reality is that the underlying capital is not needed either then that should be extracted from the estate by a lifetime gift.

Give priority to growth assets

Ideally lifetime giving should focus on assets which are expected to grow in value. Consider the possibility of transferring shares or property where growth can be anticipated. If such assets do not exist then cash gifts should still be considered.

A loan could give some flexibility

One of the drawbacks to lifetime giving is the fear that the assets which you might want to give away could be required in later years to meet care home fees. This is an understandable fear but there may be an alternative to consider – a loan.

A loan freezes the value of the monies lent in the lender's estate. The borrower would invest the money to secure growth which would accrue in their estate and so prevent any future increase in the estate of the lender. To ensure that the loan itself does not give rise to an inheritance tax charge, the loan is usually expressed to be interest free and repayable on demand, so that there is no immediate reduction in the value of the lender's estate.

However, if later the loan is written off in whole or in part this will then comprise a PET. An opportunity could be taken to write off £3,000 of the loan each year to use the annual exemption.

Example

Jane has surplus cash in her estate and is considering a possible investment in a property. She is also aware that she has a significant IHT problem already. She is worried about future care costs and wants to leave some options open. She could consider loaning the funds to her daughter who could then buy the property. The growth in the value of the property would then accrue in the daughter's estate.

What if the value of the gift falls by the time I die?

The short answer is that there is no problem. Where the value of the asset drops between gift and death but is chargeable - then the 'fall in value' relief reduces the amount charged to tax.

Can I give away assets and still benefit from them?

The answer is no! There are rules called the 'reservation of benefit rules' which effectively negate the effect of a gift where the asset transferred is not enjoyed by the recipient to the exclusion of the donor. The most obvious example would be trying to give away your home but wanting to continue to live in it. To be effective a gift must be absolute. This particular issue can be overcome where the donor pays a market rent for its continued use but please take professional advice before taking action to ensure the rules are not being breached.

Are there any downsides to lifetime giving?

Where cash is being given away there should be no problem. A potential major disadvantage of lifetime giving centres on the capital gains tax (CGT) position where other assets are involved. Even if the transfer is a PET for IHT purposes it will almost certainly be a transfer between connected parties and will be deemed to be at market value for CGT purposes. The extent of this problem obviously depends on the amount of gain which is inherent in the value of the asset when it is gifted. Although CGT may only be chargeable at 10% for certain qualifying business disposals with Entrepreneurs' Relief, the position for investment assets is higher. A basic rate income tax payer is charged 18% and a higher rate taxpayer 28%.

If the assets being transferred are business assets it is possible to claim 'hold-over relief' which effectively passes the asset and the inherent gain to the recipient. This is generally not available on assets such as quoted shares.

Longer term savings can be made using a trust

The thought of establishing a trust may seem a daunting one at first and it has to be said that there are many issues to consider on this. However, using a trust can be a very tax efficient way not only of reducing the estate of the donor but it can also contribute to the IHT planning of recipient beneficiaries, as well as avoiding the CGT problem highlighted above.

A transfer into a trust in lifetime is now a chargeable transfer which means that unless the initial value is below the nil rate band (0%), it is taxed at 20%. There is no initial charge where the transfer comprises assets which qualify for 100% business property relief. (See below for further detail) .The fact that the transfer into the trust is chargeable (0% is still a chargeable rate!) any capital gain can normally be deferred until the asset is finally sold. It should be noted that this relief would not be available if the beneficiaries of the trust included the spouse / minor children of the transferor.

The long term advantage of using a trust is that once the assets are placed into trust they cannot be taxed as part of the estate of any beneficiary. This means they can avoid having a potential 40% IHT charge which could arise if they were in a personal estate. There is a charge every ten years in the trust but this cannot exceed an IHT rate of 6% of the value of the trust assets and in practice will usually be much less.

Trusts are a complex area and we would be happy to discuss them in more detail with you.

Business property

Gifts of assets which qualify as business property may be subject to 100% Business Property Relief (BPR) for IHT. There are a number of qualifying conditions which need to be met but no financial limit applies and it is available on a world wide basis. Qualifying business property includes shares in an unquoted trading company or an unincorporated trading business. Where the relief is available in full, any chargeable transfer for IHT is reduced to nil, keeping the nil rate band intact for other chargeable assets. Securing and then using BPR effectively is critical to many in their overall IHT saving strategy so being aware of the key risks is vital.

One of those risks could stem from lifetime giving. Where qualifying shares/ business have been gifted during lifetime, BPR is only provisionally applied. If the individual who makes the gift then dies within seven years, the gift could become chargeable if it does not continue to meet the qualifying conditions at the time of death. There is probably less risk of this occurring if the business or shares have been transferred into a trust but nevertheless it is not risk free. This explains why transfers of business property are often done at death in a Will to ensure BPR is not wasted.

Similar issues can apply with agricultural property which may qualify for either BPR or agricultural property relief depending on precise circumstances.

What do you need to do now?

1. Look at the total value of your estate. Add up everything and be realistic about the values. If you own assets jointly then show the respective values in each estate. If you think you have assets such as unquoted trading company shares which would qualify for 100% relief show them at their current cash value.
2. Deduct £325,000 from the value and take 40% of the remainder – this will show the potential IHT payable if you were to die now.
3. That gives you an indication of the current size of your IHT problem. Now think about whether it is possible to make some lifetime transfers to reduce the potential bill. The sooner you start – the better the chance of making some savings - so contact us.

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