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GUIDE

# INHERITANCE TAX

## WHAT IS INHERITANCE TAX?

Inheritance tax (IHT) is, essentially, a tax levied on any transfer of assets to other people or trusts. It is typically paid in respect of the value of your estate on death, but it can also apply in respect of certain transfers of assets during your life.

If you die when 'domiciled' or 'deemed domiciled' in the UK, then IHT applies to all of your assets wherever it is situated. Domicile is a technical concept which identifies your permanent home. If you died domiciled abroad, then the tax only applies to assets situated in the UK.

Under current legislation, IHT is often perceived as a voluntary tax. This is because with careful planning, it is possible to reduce or remove any liability altogether.

### The Tax Liability

It is a popular misconception that you need to be particularly wealthy to incur a substantial IHT liability. When you die, the value of your taxable estate is calculated. This is the total value of all your possessions and assets, less any available exemptions and relief. If the taxable estate exceeds the nil rate band of £325,000 then the excess is all taxed at 40%. This rate is frozen until 2021.

### What is the Residential Nil Rate Band (RNRB)?

Legislation introduced in 2016 offers qualifying estates an additional RNRB of up to £175,000. This additional allowance is being phased in over the next four years:

- £100,000 to 5 April 2018
- £125,000 to 5 April 2019
- £150,000 to 5 April 2020
- £175,000 to 5 April 2021

There are limitations on which estates are entitled to this additional threshold and the relief is tapered for estates valued at over £2 million.

### Will you have an Inheritance Tax Bill?

IHT is payable on death if you make a transfer of chargeable property which, after deduction of liabilities, exemptions and tax relief, exceeds the nil rate band.

### Who Pays Inheritance Tax?

- Domiciled individuals.
- Deemed domiciled individuals – resident in the UK in 15 out of previous 20 tax years.
- Residents; non-domiciled individuals are liable on their UK assets only.

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## Chargeable Property

This is the value of your worldwide assets that you transfer to other individuals or trusts and that you leave in your estate when you die. However, if the transfer is made to your spouse or registered civil partner, it will be exempt from IHT. This only applies if you and your spouse or partner is UK domiciled.

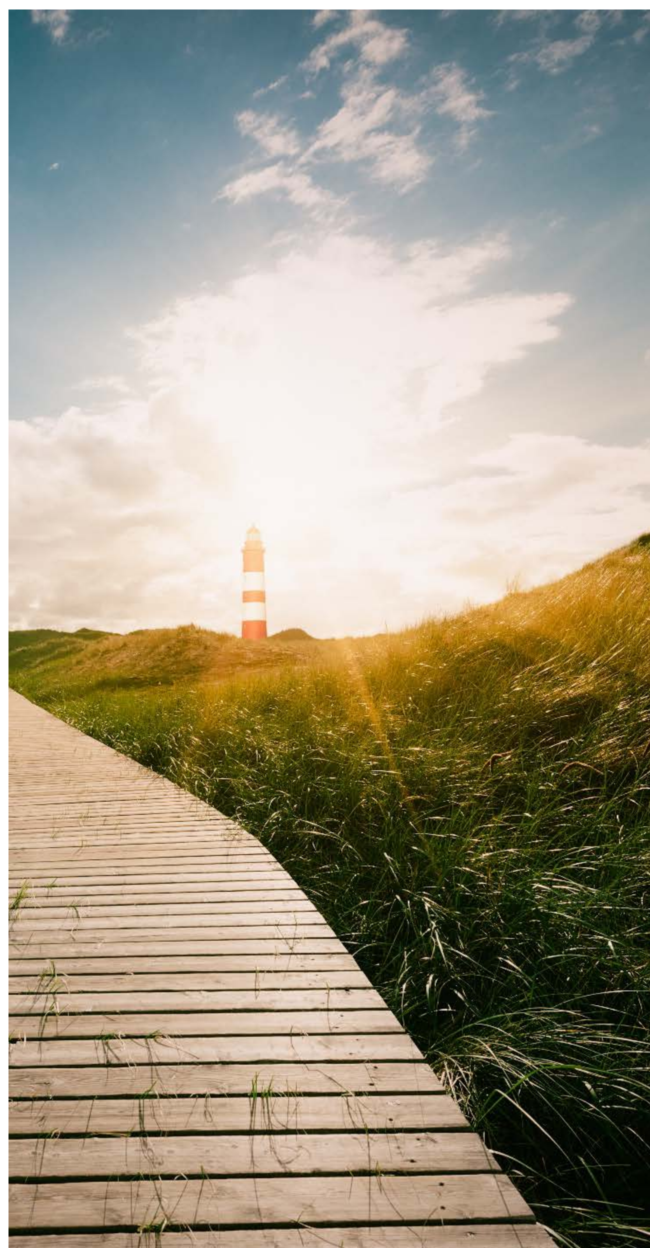
## Liabilities

Liabilities are reasonable funeral expenses, mortgages, outstanding loans and other debts.

## Exemptions

Exempt transfers are those which can be made without a tax liability. The most important include:

- Spouse exemption - transfers between spouses and registered civil partners whether during life or on death.
- Charities - Gifts and bequests to a charity that is a UK registered charity or other qualifying body (such as hospices and orphanages).
- National Benefit - Gifts and bequests to certain national institutions.
- Political Parties - A transfer of value to a qualifying political party.
- Housing Associations - transfers to a registered housing association. (now registered social landlords.)
- Family Maintenance - Payments made in favour of dependent relatives that make reasonable provision for their care or maintenance.



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## TAX RELIEF

Certain assets get relief from IHT. The most important include:

### Business Relief

If you own a business, then you can get 100% IHT relief if it meets various conditions, and if you own assets that you use in your business, you can get 50% IHT relief.

The eligible assets, and the rate of tax relief, are as follows:

- ★ A business or interest in a business – 100%
- ★ An interest in a business partnership – 100%
- ★ A holding of shares in an unquoted company – 100%
- ★ A controlling interest in a quoted company (more than 50% of the voting rights) –50%
- ★ Land, buildings or plant and machinery used in your business – 50%

Business property does not qualify for the tax relief unless you have owned it for at least two years.

Shares in an unquoted company include AIM shares (Alternative Investment Market). The relief will not be available if the business is engaged wholly or mainly in dealing in securities, stocks or shares, land or buildings, or is an investment company. If there is a binding contract for sale, such as a 'buy and sell' agreement, relief is not available.

### Agricultural Property Relief

If you own a farm, then you can get 100% IHT relief, if it meets various conditions. These are that:

- ★ you have the right to vacant possession of the property or the right to obtain it within the next twelve months, or
- ★ the land is let on a grazing licence, or
- ★ the property is let on a tenancy beginning on or after 1 September 1995.

In addition, you must have occupied the property for at least two years or, alternatively, owned the property for seven years and throughout that period it has been used for agricultural purposes. The agricultural property must be located in the UK, Channel Islands, Isle of Man or European Economic Area and includes:

- ★ farmhouses, cottages or buildings, which are of a character appropriate to the property
- ★ woodlands and buildings used for livestock
- ★ growing crops included with the land
- ★ stud farms engaged in the breeding and rearing of horses
- ★ land and buildings used in the cultivation of short rotation coppice
- ★ any land within a habitat scheme

Please note that if the farm buildings have a lifestyle value, for example a farm cottage could be sold as a second home, that additional value will not attract agricultural relief.

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## HOW TO MITIGATE INHERITANCE TAX

Even taking advantage of the lifetime gifts provisions may not be enough and a substantial potential tax liability could remain. But there are still steps that can be taken to ensure the tax bill at the end of the day will be minimised.

### Lifetime gifts

As mentioned previously, the simplest method of reducing the value of a taxable estate is to give away surplus cash and assets, then to survive for a period of seven years. This can be to individuals or to a trust arrangement. It must be an outright gift to be effective; for example, the gift of a house subject to continuing occupation at less than a commercial rent is likely to be ineffective. When a gift is made, it will normally be exempt, relieved, or potentially exempt. One category of lifetime gift that can be subject to an immediate IHT charge is a gift into a specific trust arrangement termed a discretionary trust.

Examples of exempt lifetime gifts, in addition to those already mentioned are:

- ★ **Annual exemption –** lifetime transfers of up to £3,000 each tax year are exempt from IHT. If the whole of the £3,000 is not used in any tax year, the balance can be carried forward to the next tax year.
- ★ **Small gifts exemption –** outright gifts of up to £250 in any one tax year to any number of people are exempt from IHT.
- ★ **Normal expenditure out of income –** lifetime gifts which are of a regular nature, and made from net income, qualify for an exemption if they do not affect your normal standard of living.
- ★ **Marriage gifts exemption –** gifts made by certain people in consideration of a marriage or a civil partnership taking place are exempt: from a parent: £5,000, from a grandparent: £2,500 and from others: £1,000.

### Will planning

- ★ **Exempt transfers.** Any gifts or bequests in favour of 'exempt' beneficiaries are free of IHT. For example, a gift in favour of a surviving spouse or a charity is exempt from tax.
- ★ **The nil rate band.** The law of inheritance tax allows an individual to transfer as much as they like to a UK domiciled spouse or registered civil partner, without liability and, with effect from October 2007, any of their unused nil rate band.
- ★ **Will Trusts.** It is possible for you to include a discretionary trust in your will on death. You could use this to hold any business or agricultural property, thereby using the 100% tax relief available.

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## Use of trusts

There are a number of trusts which can be used, the suitability depending on the precise requirements of the individual and the tax consequences of the trust. Some of the reasons for establishing a lifetime trust include:

- ★ The ability to make a gift of assets while maintaining control.
- ★ Providing for minor children who are too young to take legal responsibility for gifted assets.
- ★ To avoid or reduce IHT, capital gains tax and income tax.
- ★ To provide a flexible environment for the future Lifetime gifts into trusts are generally chargeable lifetime transfers.

## Types of trust

- ★ **Bare trust.** A bare trust is one under which the beneficiary is absolutely entitled to benefits (both income and capital). At age 18, a beneficiary, who is absolutely entitled, can call for their share of the trust fund to be paid to him or her.
- ★ **Discretionary trust.** A trust where a list of named beneficiaries, or categories of beneficiary, are entitled to the trust fund. The trustees have the discretion to appoint capital and income to any beneficiary or beneficiaries. It is important that the person creating the trust reserves no benefit from it or there may be adverse tax consequences.
- ★ **Discretionary Will Trusts.** If the will trust is discretionary in nature, the surviving spouse, children and grandchildren can be beneficiaries. The trustees can decide who should benefit from income and capital and can make appropriate payments. So, for example, capital or income could be appointed to the surviving spouse as and when required leaving the rest of the trust intact for distribution to children or grandchildren after the surviving spouse's death.

Alternatively, if the trust includes an appropriate provision, the trustees may make loans to the surviving spouse which comprise debts against her estate, reducing its value for inheritance tax purposes.

## Chargeable lifetime transfers (CLTs)

These are transfers which are neither exempt, nor potentially exempt. The most common chargeable transfers, into trusts, are lifetime gifts into discretionary trusts. A transfer will be chargeable if it (together with any transfers made in the previous seven years) exceeds the inheritance tax nil rate band.

Tax is payable at 20% on the excess over the nil rate band and the transfer will not be included in the estate on death if the person survives for seven years. If death occurs within seven years, then tax at death rates will apply to the transfer retrospectively. Credit will be given for the tax already paid.

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In addition to the tax charge on creation of the trust, a ten yearly periodic charge is raised at the special rate of 30% of the current lifetime rate that is 30% x 20% = 6%. This tax rate is applied to the amount by which the trust fund exceeds the nil rate band at that time.

A proportion of this tax will be payable on distributions from the trust during a ten-yearly period.

## Reservation of benefit

Any attempt by the person making the gift to reserve a benefit is likely to invalidate the original gift. Examples include a gift of shares, while retaining the right to dividend income, or the gift of a house subject to a right of rent free occupation. Where the person making the gift reserves a benefit for himself, then the value of the property in question at the date of death will be included in the deceased's estate for IHT purposes.

## Order of gifting

When considering making lifetime gifts, the order in which you establish any new IHT planning structures is critical. Where a number of strategies are being considered to solve a specific IHT situation, a suggested order of transactions (with at least one day between each structure) is as follows:

- ★ Gift and loan trust
- ★ Whole of life plans
- ★ Discretionary gift trust
- ★ Bare trust

However, the actual order depends on your individual circumstances and you should take expert advice in this regard before entering into any arrangements.

## Pre-owned assets tax (POAT)

POAT was introduced in 2004 as an anti-avoidance measure, designed to curtail the use of certain IHT planning arrangements. There is an income tax charge on the benefits received by the former owners of property, which they had transferred to certain arrangements.

## Potentially exempt transfers (PETs)

This is a term which describes gifts of cash and assets which, subject to certain conditions, will not incur a liability to IHT. Specifically, gifts between individuals or into bare trust arrangements are termed PETs. A PET made more than seven years before death becomes an exempt transfer. If death occurs within seven years, then the gift becomes taxable, subject to any taper relief and the nil rate band. Taper relief is a reduction in any tax payable in respect of the gift, which increases from 20% at three years to 100% after seven years.

PETs also occur in respect of gifts made into bare trust arrangements. Specifically, a gift into trust which earmarks the trust fund for 'absolute' beneficiaries is a PET.

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## INVESTMENT BASED SOLUTIONS

Investment bonds are commonly used in IHT mitigation arrangements, as they make ideal trust investments. They can be obtained from UK life offices or from offices based in offshore jurisdictions.

The choice of asset does not affect the IHT position, but may affect the settlor's income tax or capital gains tax position as well as the eventual amount received by the beneficiaries.

### Single premium bonds

A capital sum could be invested, with the policy written under trust for the beneficiaries of an estate. This would be an outright gift, denying the investor access to the capital invested. The investor has full control of the investment while alive.

### Discounted gift trusts

This is an arrangement using a single premium investment bond and a specially drawn up discretionary trust. This allows an individual to make substantial gifts into a trust but retain the right to receive a chosen level of payments during his or her lifetime. If the individual dies within seven years, the value of the gift for IHT purposes is reduced because of the retained right to income payments. Therefore, only the discounted value is included in the calculation of inheritance tax payable. After seven years the residual fund will be outside of the individual's estate. Growth on the investment will always be outside of the individual's estate.

### Gift and loan schemes

These are designed to couple IHT savings with full access to capital. The investor establishes a trust for, say, £10, for his prospective beneficiaries. He then makes a significant loan to the trustees, expressed to be interest free, repayable on demand. The trustees invest this in a single premium bond, then take annual part withdrawals and pay these to the investor in repayment of the loan. These will typically be set at 5% pa, repayable on demand.

The advantages of this type of scheme include:

- ★ An initial gift which will usually be covered by the investor's annual IHT exemption
- ★ Any growth in the investment is outside of the investor's estate for IHT purposes
- ★ A reduction in the value of the investor's estate over 20 years, assuming that the loan repayments are spent as income

The principal disadvantage of this type of scheme is that IHT savings take place over a 20-year period.

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## Back to back schemes

The purchaser buys an annuity which reduces the value of the estate by the purchase price involved. The income produced is used to fund a whole of life policy, written in trust for the appropriate beneficiaries. Adequate medical evidence must be taken to support the whole of life application. These schemes tend to be more attractive to elderly investors when interest rates and, consequently, annuity rates are higher.

## Insurance based solutions

Life assurance can play a role in either meeting or reducing a prospective IHT liability.

Whole of life assurance is the oldest established, and arguably the most effective method of meeting an IHT liability. As the date of death is uncertain, a whole of life policy is effected to ensure that capital is available at death to meet the IHT bill. Policies are normally written under a suitable trust arrangement to ensure that the policy proceeds do not comprise the deceased's estate on death. Premium payments may be treated as CLTs, unless covered by the annual or normal expenditure out of income exemptions.

## TAXATION

This document is based on Stellar Asset Management Limited's understanding of applicable legislation, law and current HM Revenue & Customs practice. It is provided solely for general consideration. The information regarding taxation is based on our understanding of current legislation, which may be altered and depends upon the individual financial circumstances of the investor.

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