FACTSHEET

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INHERITANCE TAX

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WHAT IS INHERITANCE TAX?

Inheritance Tax ('IHT') is a tax which is levied by Parliament and applies to all property and assets wherever situated, held by an individual if domiciled in the United Kingdom. Even if an individual is domiciled outside the United Kingdom but has assets in the United Kingdom IHT may be chargeable upon the property and assets held in the United Kingdom.

The main charge arises when the value of an individual's estate on death is cumulated with any chargeable lifetime gifts made by the deceased seven years before his or her death (with the exception of certain exempt transfers) and these exceed the 'nil rate band' (otherwise known as the 'nil rate threshold'). The nil rate threshold as from the 6th April 2009 is £325,000. It is increased annually by Parliament in line with inflation.

Where a transfer is made within seven years of death and it is above the nil rate threshold, it will become chargeable upon death at the full rate, but the tax will be tapered for transfers made more than three years before death.

Transfers for the purposes of IHT take place either on your death (a 'death transfer') or during your lifetime (a 'lifetime gift') where the transfer is made to an individual or into a trust.

Outright gifts to an individual and gifts made by individuals ('the transferor') into certain types of trusts cease to be taken into account for the purposes of calculating IHT on death, provided the transferor survives seven years from the date of the gift.

The full rate of IHT payable on transfers above the nil rate threshold is currently 40%. Lifetime gifts made by an individual into a 'discretionary trust' and which at the time of the gift exceed any unused nil rate band of the transferor, are immediately chargeable to IHT at the lower rate of 20%. If the transferor then dies within seven years, additional tax will become payable on the gift passing into the discretionary trust, but the value of the gift is frozen at the time it was made.

When calculating the extent of your estate you need to include not only the value of your house, car, savings and shares but also any death benefits which may be payable to your estate from life insurance or pension policies or any death in service benefits which your estate may be eligible to receive from your employer.

In addition to your own personal estate you also have to add any benefits that you may receive from a life-interest trust as the total value of the trust is aggregated (added to) with the value of your personal estate for IHT purposes. Certain gifts made seven years prior to your death (and in some cases gifts made within 14 years) will also have to be aggregated with the value of your estate

WHEN IS IT PAYABLE?

IHT may be payable when you make a transfer to another person, thereby reducing the value of your estate. A husband and wife are taxed separately, so any available exemptions for IHT apply to each of them and each can make transfers free of IHT up to the nil rate threshold.

If a married person gives their estate to their spouse on death, no IHT is payable as 'spouse exemption' is available. However, when this occurs the survivor's estate may thereby be substantially increased. The law now recognises this and from 9th October 2007 the unused nil rate band of the deceased spouse/civil partner, is available to the survivor on their death.

POTENTIALLY EXEMPT TRANSFERS

Most lifetime gifts are potentially exempt transfers (PET's) and will only give rise to a liability for IHT if, having made the gift, the transferor dies within seven years. If the gift is taxable there is an annual sliding scale on the tax payable until seven years elapses after which time the total gift is exempt from IHT.

Many of the transfers you are likely to make in your lifetime are wholly exempt from IHT, because you survive the gift by seven years. PET's will be taken into account on your death in deciding how much, if any, of the nil rate band is still available to set against the value of your estate.

The effect of **Capital Gains Tax ('CGT)** should be carefully considered when making lifetime gifts because such a gift may be liable to capital gains tax, a lifetime gift of a chargeable asset will be liable to CGT, and the burden of that tax may outweigh any eventual saving in IHT.

NIL RATE BAND DEBT/CHARGE SCHEME
OBJECT OF THE SCHEME:

1. The object of the Scheme is to make use of the inheritance Tax (IHT) nil rate band. Under the old rules which were changed by the Autumn Budget in October 2007 the value of everyone's estate above £300,000 was taxed at 40% when that person died. The only notable exception with this tax was that married couples and civil partners could transfer unlimited assets between each other without being liable for the tax when one of them died. This has now changed. You need to take note of the fact that despite the headlines in some of the press the threshold has not actually been increased. The change does however mean that married couples or civil partners are now able to transfer the unused element of their IHT - free allowance to their spouse or civil partner when they die. For a good number of married couples or civil

partners this change will in real terms double the tax free amount they can leave to their children.

2. You must note that Inheritance Tax at 40% above £325,000 on the estate of a single or divorced person will still be applied unless there is any other exemption.

THE SCHEME WORKS AS FOLLOWS:

1. Both husband and wife make Wills creating a Discretionary Trust of an amount up to the nil rate band (or less if appropriate) leaving the residue (the remainder) of their estate to each other. The beneficiaries of the Trust will include the surviving spouse and other family members, typically children and grandchildren. Suitable Trustees of the Discretionary Trust would be appointed to administer and manage the Trust.

2. Any ***'Joint Tenancy'*** of the family home needs to be severed at this time so that husband and wife own the property as ***'Tenants in Common'***, thereby ensuring that each spouses interest in the home will pass under his or her Will rather than automatically by survivorship to the other.

3. It is also advisable, when making the Wills and severing any Joint Tenancy, to check whether, at any stage, there has been a gift of the family home, or any share of it, between husband and wife. If there has, then the ***'Charge'*** rather than the ***'Debt'*** Scheme should be used when the husband dies (see below*).

4. On her husband's death, the widow acquires the whole of his estate from her husband's Executors, including his share of the family home. She acquires it subject to a ***debt,*** that is to say a liability to pay to her husband's Discretionary Trustees the amount of the nil rate band, (or lesser amount if appropriate) at some time in the future.

5. If there has been a lifetime gift of any part of the family home by the widow to her husband, then in order to avoid what are known as the 'Artificial Debt Rules' the husband's Executors should ***charge*** the nil rate band on the residue which is left to the widow, rather than accepting a promise by her to repay a ***debt*** of that amount.

BENEFITS OF THE SCHEME:

1. The result of the above is that the widow will acquire all the combined assets, but when she dies the value of her estate will be considerably reduced by the substantial ***debt*** owed by her to the Discretionary Trustees which will still be outstanding (or ***charge*** on her estate if the Charge route has been used).

2. If it was agreed between the Trustees and the widow at the time of her husband's death that the ***debt/charge*** would bear interest, then this will further increase the amount of the debt due from the widow's estate and will further reduce her estate for IHT purposes.

3. When the debt is repaid by the widow's estate to the Discretionary Trust Trustees, they can, at their discretion, distribute the amount of the money repaid amongst the other beneficiaries, for example children and/or grandchildren.

4. The Scheme has a number of advantages, over and above the potential for saving IHT

on the widow's death. She can remain in the family home with no risk of loss of security.

5. The Scheme is relatively straightforward to provide for, the appropriate Wills should be put in place and any Joint Tenancy severed. The decision as to how far to implement the Scheme need not be taken until the husband dies. If the widow does not need to benefit from the Discretionary Trust, then the Scheme need not be used, the Trust Fund could instead be appointed to other potential beneficiaries of the trust, or indeed to the widow herself, if IHT on her own estate is no longer a problem.

RESERVATION OF BENEFIT

Property that you may give away is still treated as belonging to you for IHT purposes if you continue to enjoy any benefit from the gifted property.

You will be treated as retaining a benefit in property if there is some interest, right or arrangement which enables you to occupy or otherwise enjoy the asset given, and you do not pay full consideration for this, such as rent in the case of a house, which you have given away and then continue to occupy.

If you retain a benefit in gifted property at the time of your death, it will be treated as part of your taxable estate.

TAX TREATMENT OF PRE-OWNED ASSETS

From 6 April 2005 a free-standing income tax charge will be made on individuals who benefit from either free or low cost enjoyment of assets they formerly owned (or provided the funds to purchase). It is proposed that the rule will broadly follow the benefit in kind charge arising on employees; the rules will quantify an annual cash value for the benefits enjoyed by a taxpayer and will be treated as additional taxable income. A de minimus threshold will apply of £5,000 per annum. The charge will apply when a benefit is received in chargeable circumstances in or after the tax year 2005-06. The proposed charge will **NOT** apply to the extent that:

- The property in question ceased to be owned before 18 March 1986
- Property formerly owned by a taxpayer is currently owned by their spouse
- The asset in question still counts as part of the taxpayer's estate for IHT purposes under the existing 'Gift with Reservation' (GWR) rules
- The property was sold by the taxpayer at an arm's length price, paid in cash: this will not be restricted to sales between unconnected parties
- The taxpayer was formerly the owner of an asset only by virtue of a will or intestacy which has subsequently been **varied by agreement** (ie by a Deed of Variation) between the beneficiaries
- Any enjoyment of the property is now more than incidental, including cases where and out-and-out gift to a family member comes to benefit the donor following a change in their circumstances.

More generally, former owners will not be regarded as enjoying a taxable benefit if they retain an interest which is consistent with their ongoing enjoyment of the property. For example, the proposed charge will not arise where an elderly parent formerly owning the whole of their home passes a 50% interest to a child who lives with them.

I DON'T THINK I'M WEALTHY ENOUGH TO WORRY ABOUT IHT

Many people believe that they are not wealthy enough to worry about IHT. However, if you stop to add up the value of your estate, for example, your home if you are a home owner, the value of any insurance policies payable on your death, your savings and any investments, your car, personal effects and contents of your home - you may be surprised at the total value of your estate, especially if you are married and you combine your spouse's assets with your own. You may find that the value of your combined estates is substantially over the IHT threshold. If this is the case, and no steps are taken to mitigate the possible impact of IHT, the survivor's estate in so far as it exceeds the nil rate threshold would suffer tax of 40% on their death.

All individuals can utilise their nil rate band in their Will. Often they fail to do so and leave their entire estate to their surviving spouse. As a result they have lost a potential IHT savings of 40% of the nil rate band of £325,000, i.e. £130,000. With effective use of just the basic Inheritance Tax exemption the amount of IHT payable on death could be substantially reduced if not wiped out completely.

EXEMPTIONS

Many gifts are completely exempt from tax. Others are exempt only if they are made in lifetime. The exempt lifetime gifts are as follows:

- **Small gifts to same person** – Any outright lifetime gifts to any one person in any one tax year if the total gifts to that person do not exceed £250 in that year. This allowance is frequently overlooked and there is no limit to the number of persons to whom the £250 can be given and the recipient of the gift does not have to be related to you. The gift must be an outright gift but can be of cash, chattels (specific items) or investments.
- **Gifts in consideration of marriage** – Wedding gifts of up to £5,000 by a parent to children (including step-children and adopted children) or the person that your child is marrying; £2,500 to each grandchild or the person that your grandchild is marrying; or £1,000 to anyone else.
- **Annual transfers not exceeding £3,000** - The first £3,000 of lifetime transfers in any tax year is exempt. Any unused portion of the exemption may be carried forward for **one year only** for use in the following tax year after the exemption for that following tax year has been used. If therefore the previous tax year's exemption has not been used then a total of £6,000 can be given away in that particular tax year. As this is a personal allowance a married couple utilising the current and previous year's exemptions could each give away £6,000 making a total of £12,000 jointly. As with Small Gifts exemption the gift does not have to be a cash asset but could include shares or chattels. The effect of using the annual exemption allowance over a number of years could result in a considerable IHT savings. If you intend to make such gifts it is sensible to make a note of the date such gifts have

been made and to whom.

- **Normal expenditure out of income** – To obtain this exemption the gift must be part of your normal expenditure and must not, taking one year with another, reduce your available net income (after all other transfers) below that required to maintain your normal standard of living. In making the gift the donor is required to be left with enough money to live on their income without resorting to any capital assets to see them through the month. It is essential that a regular pattern is set up for instance by way of standing order through your bank account. The amounts do not have to be of the same regular amount provided there is a clear commitment to make such payments. It is very useful to confirm any intention to make such gifts by way of a letter from the donor to the donee confirming the gift. The exemption will often apply to life assurance policy premiums paid for the benefit of someone else. This is a very useful exemption provided that any such gifts made to be claimed under this exemption must be correctly applied. Any payments made however large are allowable and do not have to be declared to the Inland Revenue.

- **Capital transfers for family maintenance** – You may sometimes need to make transfers of capital to provide for your family, e.g. following divorce, when the usual exemption for transfer between husband and wife no longer applies, or to make reasonable provision for a dependent relative e.g. a child under 18 or in full-time education.

Other exemptions are available whether the transfer is made in lifetime or on death**.** These exemptions are transfers between UK domiciled spouses; gifts to UK charities, to political parties, for national purposes e.g. National Trust or British Museum and gifts of heritage property such as paintings by well known artists etc. By careful use of the above exemptions you can gradually reduce the size of your estate which, if the value of your estate exceeds the nil rate band, will in turn reduce the amount of IHT that your estate will have to pay in the event of your death.

Another method of inheritance tax planning is by life assurance cover whereby your beneficiaries are nominated to receive the proceeds of any life insurance policy (often written in trust) which is payable immediately after your death to meet any IHT liability that may become payable. It is essential that before taking out any such life assurance cover you discuss this fully with an Independent Financial Adviser.

It is also possible to nominate death benefits payable from occupational pensions directly to your beneficiaries thereby removing the value of such funds from your estate as they are payable outside your estate, directly to your beneficiaries.

RELIEFS

Valuable reliefs are also available for individuals who own private businesses or agricultural property. In many cases, provided certain conditions are satisfied 100% relief from IHT is available. If so, the value of the asset will not be included and IHT will not be charged upon it. In other cases 50% relief may be available.

POST DEATH VARIATION

All is not lost if no tax planning has been undertaken by an individual by his or her Will. This is because the law allows the personal representatives and beneficiaries of an estate to rearrange the distribution of the assets after the death. For example, if a husband dies leaving all his assets to his wife and she does not require all or part of her husband's estate, the widow and personal representatives can enter into a Deed of Variation whereby all or part of the estate is redirected to other relatives or persons.

In effect the Will of the deceased is rewritten and the Inland Revenue treat the gifts as contained in the Deed of Variation as having been made by the deceased. Any such Deed must be completed within two years of the death.

When you have considered this brief outline on IHT and related issues you may feel that IHT is a somewhat complex subject. However, tax planning is important if you think that on your death, or on the death of you and your spouse if you are married, the estate may exceed the nil rate band, resulting in a charge for IHT. Effective tax planning can substantially reduce, and even eliminate such a charge.

You need to remember that any Inheritance Tax Planning will involve you or your estate in some significant expenditure in legal fees or insurance or gifting away of your property and it is your children or beneficiaries who will derive the benefit not yourself but any such gifts made will result in the Inland Revenue being the loser! It is most important that any gifts that you do make do not result in your suffering personal financial hardship. It is therefore vital that you seek professional help before deciding on any course of action and if appropriate, your Will can be prepared to meet your requirements and incorporate effective tax planning.

At Thornleys, we are committed to providing the best possible professional service to all of our clients, both business and personal. We have produced our Fact Sheets and Articles as part of this service but they are intended only as a guide to highlight general issues which may be of interest to our clients. They are not a substitute for full professional advice. Specialist advice and assistance should be sought in relation to any particular needs or circumstances. Accordingly, no responsibility for loss, or consequential loss however occasioned to any person acting or refraining from acting as a result of any material in this publication can be accepted by Thornleys, howsoever caused.

Our Private Client team at Thornleys have the specialist knowledge and expertise in these matters. They can advise and help you with your specific needs and requirements.

FOR FURTHER INFORMATION:

On Wills generally please see our **Fact Sheet 1 - Wills** on appointing Guardians please see our **Fact Sheet 2 - Appointing Guardians in your Will** and on Trusts please see our **Fact Sheet 4 - Trusts including Discretionary Will Trusts**

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