Punter Southall
Aspire

A Guide to Inheritance Tax

What it is and what you can do to mitigate it

Inheritance Tax in its present form was introduced back in 1986, but there has been some form of tax on estates for many hundreds of years, including the 1796 tax on estates introduced to help fund the war against Napoleon. The earliest death duty can be traced back to 1694 when probate duty, a tax on personal property, was brought in.

So Inheritance Tax (or IHT as it is more commonly known) is nothing new.

However, as time has gone on, circumstances have changed as to how it's regarded. In recent years, two key things have changed. Firstly, IHT now affects more people than ever before. The key reason for this is the steep rise in property values, especially in the South East.

Secondly, the rules governing IHT are now more complicated than ever. In fact, the Chancellor, Philip Hammond, called the IHT regime 'particularly complex' and asked the Treasury to simplify the system.

Yet, interestingly, HMRC now receive more revenue from IHT than ever before. In the Tax Year 17/18, IHT receipts were in excess of £5Bn for the first time ever, an increase of 8.1% from the previous year[1]. At a time when Government finances are stretched, the Chancellor may wish to make the IHT system simpler, but it is difficult to believe that the system will be more generous to the Tax Payer.

The aim of this Guide is to provide you with an understanding of IHT. We'll discuss how and when it is calculated and what can be done to alleviate the problem in the short term and long term, using some simple examples.

Naturally, before we discuss any IHT implications you may have, the starting point of any discussion on your assets must be the assurance that your own needs are catered for: not only your day to day living expenses, but also any future requirements that may demand extra income.

For example, at some point in the future you may require some form of Long-Term Care. Whilst you may be fit and healthy at the moment, you don't know what may happen and the last thing you want to be doing is managing your IHT liability by giving money away in good faith and then finding out that you need it back to pay for your care.

It's a fine balance between holding funds back to ensure that your own needs are catered for and then finding that keeping too much back has generated an Inheritance Tax bill for your beneficiaries.

IHT is a very complex regime as well as a very personal one, so we do encourage you to seek advice if you think that IHT may be an issue for you and your beneficiaries. With careful planning, IHT can be less of an issue to many families, but advice is crucial.

However, whatever solutions we discuss, either within this Guide or with you personally, the starting point will always be to take your own needs into account. Changes to death benefits are also very important. It's these that we'll discuss here, and we'll assume that you've funded your Personal Pension to a certain level and now wish to draw benefits from it.

1: https://citywire.co.uk/new-model-adviser/news/hmrcs-iht-take-rises-to-unprecedented-levels-in-2017-or-18/a1143635

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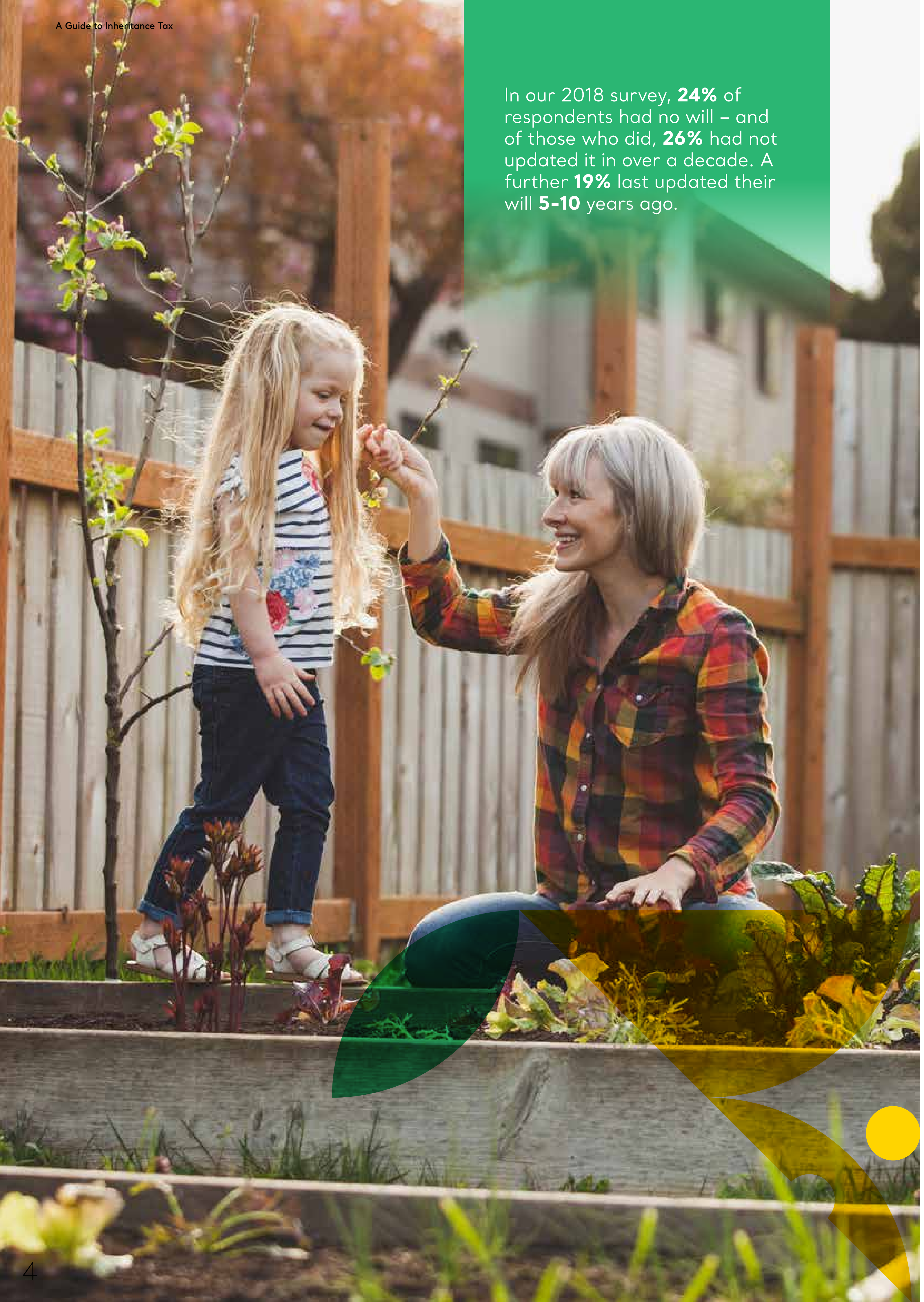

In our 2018 survey, **24%** of respondents had no will – and of those who did, **26%** had not updated it in over a decade. A further **19%** last updated their will **5-10** years ago.

So, how does IHT work?

Quite simply, IHT is a Tax on your Estate when you die. Everybody has a personal allowance of £325,000 (known as your 'Nil Rate Band') and if your Estate is worth more than that, then a calculation must be done on your death to see what tax you must pay.

At present, the tax rate for anything in excess of the Nil Rate Band is 40%. There are also further allowances that can be used to offset this amount and we will discuss more of that later in the Guide.

Your Estate is simply the sum total of what you are worth when you die. This includes all your assets such as your home, your car, other personal effects, savings and investments. It should be noted that some assets, such as your pension, are free from IHT.

If you are married or in a civil partnership, you can pass your estate to your spouse or civil partner free of IHT even if the value is more than the Nil Rate Band.

So, where do you start when it comes to mitigating IHT?

The first rule: Make sure you write a Will.

We cannot emphasise enough how important this is.

It may be that people think it is complicated or simply don't like to think about what is being considered, but a more likely reason is because people may assume that on the event of their death, their entire estate will pass to their spouse or their children whether they have a Will or not. Unfortunately, this is not the case.

By not writing a Will, you are potentially leaving your assets to be distributed according to the law, and not according to your wishes. Dying without a Will is classed as dying "intestate". This means that your estate will be distributed according to the rules of intestacy and, contrary to popular belief, this does not mean the whole estate passes to your spouse.

The rules of intestacy are quite extensive and depend on various factors such as whether you are married and also whether you have children. By creating a Will, you get peace of mind knowing that your assets will be distributed according to your wishes and not those of the Courts. Although it is possible to write a Will by yourself, it is always recommended that qualified advice is sought to ensure that your Will is valid, and it is put into safe keeping so people know where to find it quickly.

By having a Will, it will also ensure that assets can be distributed quickly to your beneficiaries. Finally, a Will should also help with IHT planning as it will enable you to take full advantage of the following IHT allowances.

By not writing a will you are potentially leaving your assets to be distributed according to the law, and not according to your wishes

Allowances

There are some allowances that can be considered when calculating your IHT liability and these can all be used to offset your IHT bill.

Some of these are automatically provided, some have to be applied for by the Executors of your Estate and some must be considered whilst you are still alive.

Let's consider the two key allowances.

Nil Rate Band

As discussed, everybody has a Nil Rate Band (commonly known as NRB). Currently this is £325,000 – it's been at that level since 2009 and will remain so until tax year 20/21. If you are married or in a civil partnership and you do not use up all your NRB allowance before or when you die, you can pass on the unused part to your spouse or civil partner.

As an example, if none had been used by the first person to die, and the whole estate had been passed to the spouse with no tax payable, when the second person died, they would have an NRB allowance of £650,000 before IHT is payable on the Estate. However, do note that this transfer is not automatic and must be claimed by the executor of the Will of the second person to die.

Whilst this is hugely advantageous, the large increase in house prices that has occurred in the last twenty years has meant that more and more people have been caught by IHT, especially as the NRB allowance remains, in effect, 'frozen' at £325,000. Therefore, in April 2017, the Chancellor introduced a new Allowance called Residence Nil Rate Band.

Residence Nil Rate Band

One of the key commitments in the Tory Manifesto back in 2015 was the ability to leave the family home to your children in your Will without it incurring Inheritance Tax. The Government recognised that property price increases had pulled many more people into the Inheritance Tax net than before. The aim, therefore, was to introduce a new allowance to keep the number of estates paying Inheritance Tax in five years' time the same as the number who paid the tax in the year 2014/15.

So, in 2017, the Government introduced the Residence Nil Rate Band or RNRB.

The first key point is that its introduction will be spread over a number of years, minimising the cost to the Treasury. The ultimate aim is for the staggered increase of the RNRB to combine with the existing nil rate band of £325,000 to give a total individual allowance of £500,000 – which is then worth £1,000,000 to a couple.

The Tapering started in April 2017, and the bands which will apply are as follows:

£100,000 in 2017 to 2018
£125,000 in 2018 to 2019
£150,000 in 2019 to 2020
£175,000 in 2020 to 2021

The above bands will then increase in line with the Consumer Price Index from 2021 onwards.

This all seems quite simple, but as we have already established, nothing is ever simple when it comes to IHT.

Firstly, RNRB will only be allocated if a person leaves a family home to a direct descendant. That can be a child or remoter descendant, or alternatively to an adopted child, a stepchild or foster child or any of their offspring. However, if you wish to leave assets to parents, siblings, nieces or nephews, only the standard nil rate band can be set against their estate. There are then implications for those people who have downsized or sold their property and also for those with estates in excess of £2M, who will see the allowance tapered.

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Downsizing your property

The RNRB is still available if you have downsized, given away or sold your home; this is known as the downsizing addition. For downsizing addition to apply, you must have downsized to a less valuable home or ceased to own a home after 8 July 2015.

Your former home would also need to have qualified for the RNRB if you had retained it and at least some of your estate must be left to your direct descendants. Calculating the downsizing addition is complicated but it's generally the amount of the RNRB that has been lost because your former home is no longer in your estate.

High Value properties

The RNRB can also be lost in whole or part if your estate exceeds £2 million. This is particularly important if you are a couple and individually your estates are less than £2 million but combined exceed this amount (this assumes that all the assets pass to the surviving spouse on the first's death). The additional threshold will be reduced by £1 for every £2 that the estate is valued at more than the £2 million taper threshold. Essentially, this means that no RNRB will be available for estates in 2018-19 that are worth more than £2.25million. If this applies to you, it's crucially important to seek advice.

It would have appeared much simpler to raise the Inheritance Tax allowance to £500,000 per person, especially when you consider that the RNRB won't be fully into effect until 20/21, by which time the existing nil rate band will have remained at the same level for 12 years. But, as has been mentioned before, IHT is complicated and this is an excellent example of that.

So, based upon what we've discussed so far, let's show a simple example.

Introducing Joan.

Joan is 80 and is widowed. She lives in a nice house and has a second property on the coast that she uses with the children and grandchildren. Her income is provided by her husband's Personal Pension and other investments that she has, including a £200,000 ISA portfolio.

Therefore, her assets are valued as follows:

House	£700,000
Second Home	£175,000
Other assets (Car, jewellery, household items)	£50,000
Investments (including ISAs, savings and bank accounts)	£250,000
Total Estate	£1,175,000
Allowances to offset	2 x NRB £650,000 2 x RNRB £300,000 Total £950,000
Amount liable for IHT	£1,175,000 - £950,000 = £225,000
IHT to pay	£225,000 x 40% = £90,000

Should Joan die, her beneficiaries will have to pay HRMC £90,000 and this must be paid within two years of her death. It can be raised by the sale of the properties or simply by encashing her investments. Clearly her children will benefit from her estate on her death, but does HMRC really have to benefit as well??

With some careful planning, possibly not.

We'll continue to refer to Joan as we progress as we think we can potentially remove some or all of this Tax liability. That is what is so important with IHT. With careful planning and advice, it is possible to mitigate the tax - however, the longer you do nothing about it, the less options you have.

So, what are some of the options when it comes to mitigating IHT?

Your Options

You broadly have four choices when it comes to dealing with your IHT liability.

1. **You can spend more (or spend differently)**. If your Estate is too big, simply make it smaller by spending more money. This is easier said than done, of course. For example, a new £20,000 kitchen will probably increase your house value by a similar amount. Buying assets doesn't really solve the problem.

2. **Give your assets away**. This is easier but has consequences. HMRC has some fairly detailed rules about how and when you give money away and we'll discuss that in more detail below.

3. **Protect against it**. If it is recognised you have a Tax liability, one solution is simply to purchase a life assurance plan which covers that liability on death. However, once again this has consequences which we will discuss.

4. **Arrange your assets**. You can rearrange your assets or simply draw income from different assets to reduce your IHT liability.

So, let's consider each in turn:

1) Spend more

This is the simple one. Most people have worked hard and should enjoy the fruits of their labour. Retirement is a time when you can finally spend time doing the things you've always wanted to do. Yet interestingly, research has shown that people only spend about 31% of their assets between the ages of 70 and 90[2]. This is mainly due to one reason: the simple fear of running out of money.

If you plan well and take good advice, spending your money is an excellent way to reduce your estate. However, if one of the key roles of spending money is to reduce your IHT liability, you need to spend it on things that don't actually increase the value of your estate. For example, as mentioned above, a new kitchen or improvements to your house could actually increase the value of the house. The purchase of jewellery will simply move the liability from your cash assets to your fixed assets, but you will still have the same liability.

Often the best way to spend money is to travel, which offers a reduction in assets. The simple purchase of experiences or memories is an excellent consideration and as of yet, HMRC haven't yet worked out how to tax those.

However, if you consider our example above, Joan is 80 years old and widowed. She may feel uncomfortable travelling by herself or is simply happy to spend more time with her family and friends at home. It may be that a better solution for her is to start reducing her estate by gifting her money to people and causes she feels passionate about.

You broadly have four choices when it comes to dealing with your IHT liability

2: https://www.ifs.org.uk/uploads/publications/bns/BN237.pdf

Your Options

2) Give it away

One way to spend your money is simply to give it to others and you would think this is a simple way to reduce your estate. We do recognise that most people can't just hand their assets over as there could clearly be a requirement for them in the future, maybe for the provision of care.

Just as importantly, for those who can gift money or assets, there are rules around gifting which require you to live for seven years before IHT is fully mitigated. You should also note that you cannot continue to benefit from the gift (for example, you can't simply give your house away and continue to live in it).

One simple idea is to utilise the allowances offered by HMRC. For example, you can gift up to £3,000 annually which immediately falls outside of your estate for IHT purposes. Whilst this may only be a small amount when calculated against the value of your estate, it is clearly an allowance that will benefit your estate in the longer term. £3,000 for one year may not feel significant, but £30,000 over ten years starts to make inroads into your IHT liability.

More importantly, if you are concerned about the Inheritance Tax that might have to be paid when you die, giving away some of your money to charity either now or in your Will can make a substantial difference as charitable gifts are exempt from IHT. One solution could be to select a few charities that you wish to support and start donating to them immediately. Regular contributions are often the lifeblood of many charities and even £50 per month would make a huge difference to them - so why not consider the difference you can make now to matters close to your heart, whilst also mitigating your future IHT bill? Note also that any gift to charity will also benefit from Gift Aid (should you pay income tax). It really does feel like a win-win situation.

Many charities benefit from Legacies left in Wills and this will also reduce your estate upon your death. In fact, if you give enough to charity, you can cut your IHT bill even further. Since 2012 it has been possible to lower the rate of IHT from 40% to 36% as long as at least 10% of your estate is given to charity.

Your Options

When it comes to gifting money, there are some key allowances that must be considered, and they are as follows.

Annual Exemption - £3,000

Note that this must be logged clearly, so that it can clearly be recognised as using the annual exemption, otherwise beneficiaries may struggle to have it acknowledged by HMRC as a reduction of your estate. You are allowed to carry forward any unused allowance from the previous year. Therefore, if you didn't make a payment of £3000 in one year, you can make up to £6000 in the next one.

Small Gifts - £250

You can give as many gifts of up to £250 per person as you want during the tax year as long as you have not used another exemption on the same person.

Again, it is very important to log these gifts accordingly.

Marriage gifts

These differ depending on who is giving the gift

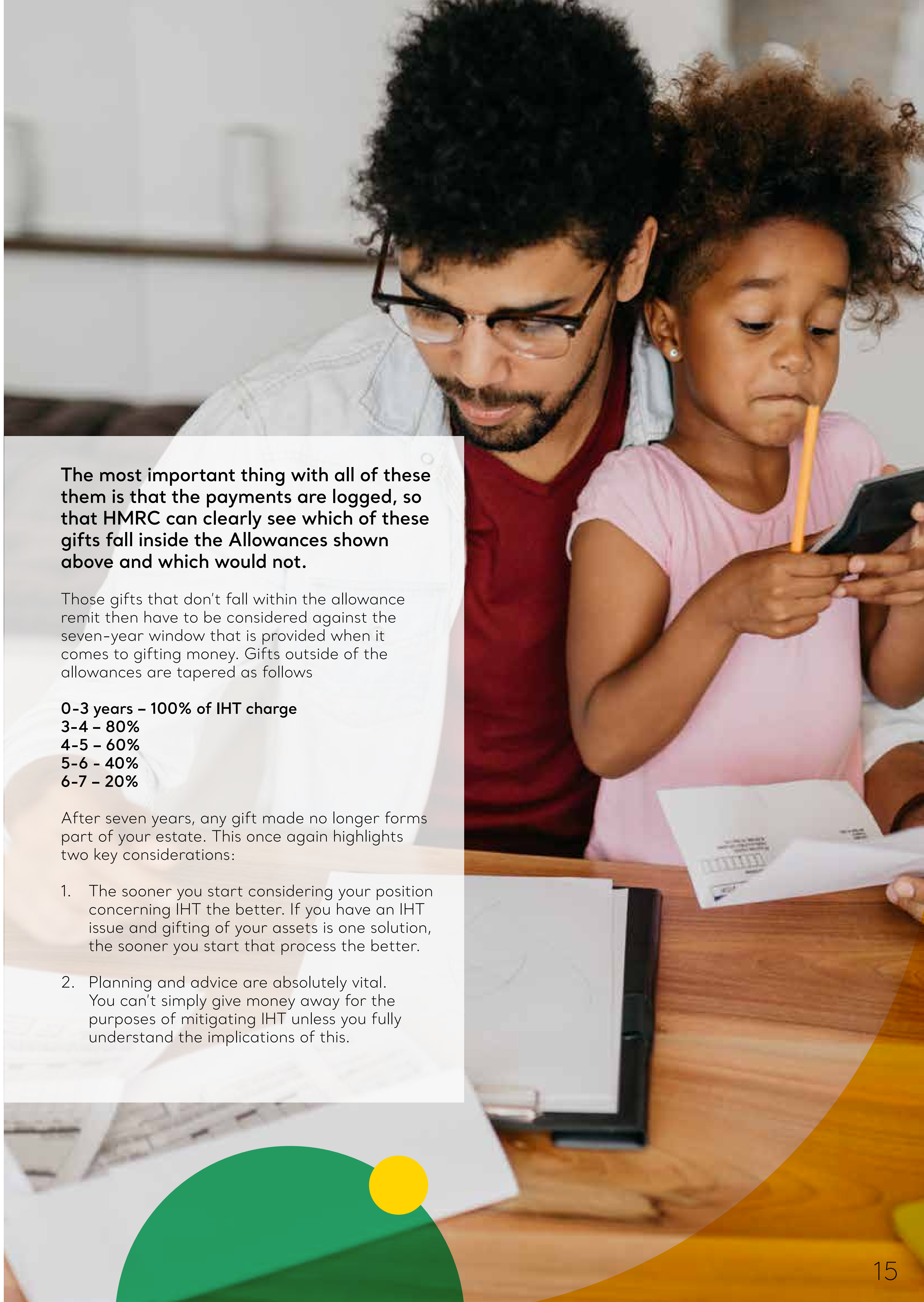
Parent - £5,000
Grandparent - £2,500
Bride/Groom (to each other) - £2,500
Other - £1,000

Other gifts

If you wish to pass on greater sums of money, the exemptions listed above may not be enough. If you wish to increase the value of IHT-free gifts you can make year-on-year, you can also consider using the 'normal expenditure out of income relief' to make gifts.

This states that all transfers, or gifts, are exempt from IHT if they meet the following criteria:

- They are made as part of your normal expenditure.
- They are made out of your 'natural' income.
- After allowing for all transfers taken from normal expenditure, you are left with sufficient income to maintain your usual standard of living.
- The payments are habitual or regular.



The most important thing with all of these them is that the payments are logged, so that HMRC can clearly see which of these gifts fall inside the Allowances shown above and which would not.

Those gifts that don't fall within the allowance remit then have to be considered against the seven-year window that is provided when it comes to gifting money. Gifts outside of the allowances are tapered as follows

0-3 years – 100% of IHT charge
3-4 – 80%
4-5 – 60%
5-6 - 40%
6-7 – 20%

After seven years, any gift made no longer forms part of your estate. This once again highlights two key considerations:

1. The sooner you start considering your position concerning IHT the better. If you have an IHT issue and gifting of your assets is one solution, the sooner you start that process the better.
2. Planning and advice are absolutely vital. You can't simply give money away for the purposes of mitigating IHT unless you fully understand the implications of this.

Your Options

Now, let's go back to Joan again.

You may recall she owns a second home by the coast and this is valued at £175,000. Surely a simple solution is to gift this house to her children, thereby reducing her estate by £175,000 and mitigating most of her IHT liability.

However, there are three key concerns with this. Firstly, as per the tapering table above, she has to live seven years for this to fully benefit the estate.

Secondly, you may recall that this second home was still used by Joan to spend time with the children. If it is deemed that she gave the property away solely to avoid IHT, and still continued to use the property in the same way, HMRC may consider the transfer of the property to be what is called a 'gift with reservation' which means some or all of it could still form part of her estate on her death (although if she pays the commercial rent for the property when she uses it, this could potentially be an effective way of overcoming the Gift with Reservation rule – but there may be other tax considerations so, as always, advice should be sought before making such a gift).

Finally, transferring the property may cause her to generate a Capital Gain on the property, which will be taxed under Capital Gains Tax rules. In fact, if she dies within three years of transferring the property, she could find herself paying both CGT and IHT on the property. Not good. Once again, what seemed like a simple solution turned out to be more complex than was expected.

We must emphasise that there isn't a perfect solution in this instance. There is no point in having Tax Rules if everybody can simply skirt their way around them. But it is quite clear to see that the sooner Joan starts planning, the easier it is to manage her situation.

Your Options

3) Protection

Like many circumstances, a potential solution is simply to insure against the problem. If your estate will generate an IHT liability on death, why not simply insure your life and cover that debt for future generations?

There are a few reasons why people don't take this option:

Firstly, it can be expensive. Naturally, you are insuring an older life,and there may be potential health issues to consider.

Secondly, due to the nature of IHT and fluctuating valuations of assets, it is very difficult to be sure that the whole debt will be covered.

Finally, and most importantly, if this is to be considered as an option, then you must ensure that it is set up properly. The last thing you want to do is find out that the life assurance payment of many thousands of pounds is also added to the estate which in turn generates further problems. This sort of arrangement must be written under Trust and advice is crucial. There are normally much better solutions, but protection can be considered.

4) Rearranging your assets

Many people have invested a lot of money into their Pension to provide themselves with income in retirement. They will often use other products and investments to provide themselves with rainy day money such as ISAs, Savings Accounts and other investment vehicles, which tend to build up over time.

This all seems to make sense, until IHT becomes an issue. A personal pension has one key advantage over many other investments in that it is IHT free. This is of huge benefit to anybody who may have an IHT issue, yet in most instances, we draw most of our retirement income from our IHT-free assets and leave our other assets to grow. They then form a bigger and bigger part of our estate, which in turn could generate a bigger and bigger IHT bill for our beneficiaries.

To highlight this further, let's go back to the situation with Joan. You may recall that she is using her husband's pension to provide her with income, whilst she has £250,000 of other investment assets. She is drawing nothing from those assets and they continue to grow, causing further IHT issues as she gets older. A potential solution may be to stop the income from her husband's personal pension and draw tax free income from her ISA portfolio.

This in turn will reduce the asset over time which will also reduce her estate for IHT purposes. This simple exercise could make huge savings. If she withdrew £30,000 per annum for five years from her ISAs as income, she would also reduce her estate by the same amount and save 40% of £150,000 in IHT, equating to a £60,000 saving.

There are other considerations such as changing the ownership of your home from Joint Tenancy to Tenancy in Common, but these are very detailed and have other implications that must be considered. Any form of exercise to rearrange your assets MUST be done with full and professional advice, otherwise it may cost you more than you save.

Conclusion

So, what should you do next?

A Chinese proverb states that "*The best time to plant a tree was 20 years ago. The second best time is now.*"

The same could be said for IHT planning.

IHT can be a very punitive tax. Everything that is in excess of the allowances offered by HMRC is taxed at 40%. Your plans to provide a legacy for your children and grandchildren can be decimated by HMRC becoming one of your biggest beneficiaries.

You need to carefully consider what your position is and start planning as soon as possible.

However, it's also vitally important that you don't allow IHT to dictate your overall requirements. The balancing act between managing your affairs to ensure you are well looked after whilst also ensuring that your IHT liability is managed is a difficult one.

So, our suggestion is that you do two things:

Firstly, do a broad calculation of your financial position. Look at the assets you own that are liable for Inheritance Tax and add them together, and then deduct your allowances such as your Nil Rate Band and Residence Nil Rate Band.

Take one number from the other and multiply it by 40%. This will provide you with a simple idea of what your IHT liability is.

Secondly, if it looks like you have an IHT problem, please do seek advice.

Remember, Inheritance Tax is one of the most complex tax regimes and it is vitally important you seek professional advice.

You need to carefully consider what your position is and start planning as soon as possible.

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Next Generation Thinking

Changing Financial Planning for Everyone

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