



Inheritance tax - an introduction

Death duties have been with us for centuries, in the guise of Estate Duty, Capital Transfer Tax and now Inheritance Tax (IHT). Irrespective of the name, the purpose has always been the same; to raise revenue from the estates of citizens.

Once considered a tax on the truly affluent, IHT now affects more estates than ever. It will undoubtedly come as a shock to many to discover that a large proportion of their wealth or estate, which includes all their assets including: the family home, investments, life assurance policies not in trust, and even old family heirlooms might actually have to be sold in order to meet the tax liability on death. It is not usually possible to sell assets until after a Grant of Representation, for example Probate, has been obtained and this is not normally possible until the IHT is paid.

While most people are aware of the existence of IHT, it is a subject which gives rise to some distaste or lack of interest and many, not surprisingly, would rather delay consideration of the matter. So few people do anything about their potential IHT liability, the result is that the HM Revenue & Customs (HMRC) anticipate collecting £3.1 billion in respect of 2008/2009* alone.

The first £325,000 (2009/2010) of an individual's estate (referred to as the nil rate band) is taxed at 0% and is not therefore liable to IHT. The entire estate in excess of the nil rate band is taxed at a flat rate of 40%. The table below shows the effect this tax can have on an estate and how HMRC could easily become the single largest beneficiary.

SIZE OF ESTATE	AMOUNT OF TAX PAYABLE	% OF ESTATE PAID IN TAX**
£325,000	Nil	0
£500,000	£70,000	14
£750,000	£170,000	23
£1,000,000	£270,000	27
£1,500,000	£470,000	31

Note: For married couples and civil partners any unused portion of the nil rate band is transferable from the first to die to the survivor.

*HM Revenue and Customs 2009

**Rounded to nearest whole percentage

Who is liable?

All individuals domiciled in the UK are subject to IHT on ‘transfers of value’ of all their worldwide assets with the exception of excluded property – see below. Those who are not UK domiciled are only subject to IHT in respect of their UK assets. The issue of domicile is beyond the scope of this brochure, however, the domicile of an individual is generally the country where he or she permanently resides or intends to remain in the future – often referred to as ‘where your heart is’.

Furthermore, for the purposes of IHT only, there is the concept of ‘deemed domicile’, which applies where:

- The individual has been resident in the UK in 17 out of the last 20 tax years, or
- The individual was domiciled in the UK within the previous 3 tax years.

Excluded Property

Certain assets are excluded from IHT. These include:

- A reversionary interest under a trust.
- Non UK assets, ie assets not situated within the UK. However, the individuals beneficially entitled to these assets must be domiciled outside the UK or the assets must be held in a trust created at a time when the person who created the trust (the settlor) was non UK domiciled.

What is a transfer of value?

A transfer of value for IHT purposes is any action or omission (usually a gift) in relation to your estate, which reduces its value. This can be during your lifetime or on death. It is not necessarily measured by the value of the asset gifted. It is calculated by reference to the loss to your estate, ie by looking at the value of the estate before, and after, the gift is made, in order to calculate the loss and therefore the value transferred.

Transfers of value will be one of three types:

- Exempt Transfers. These are transfers where IHT will never be payable.
- Potentially Exempt Transfers (PETs). These become exempt if the donor survives seven years from the date of the gift.
- Chargeable Lifetime Transfers (CLTs). These may result in an immediate lifetime charge to IHT of 20%.

Exempt transfers

Transfers Between a Husband and Wife or Civil Partners

Transfers between spouses or civil partners, during lifetime or on death, are exempt from IHT. For the exemption to apply a couple must be legally married or in a registered civil partnership. It does not apply to 'common law' partners, although there is no requirement for a married couple to be living together.

Where a transfer is being made by a UK domiciled individual to a spouse or civil partner who is non UK domiciled the exemption is limited to £55,000.

Annual Exemption and Small Gifts

Gifts of up to £3,000 per tax year are exempt. This exemption is per donor and, if not used in any tax year, can be carried forward for use in one subsequent year only. An unlimited number of smaller gifts – worth £250 or less – can also be made to any number of people, however, not to the same person who has benefited from the annual exemption.

Normal Expenditure Out of Income

Regular gifts by an individual that are made out of income are exempt. Gifts that are to fall within this exemption should not affect the donor's standard of living and should be part of a regular pattern of spending. For example, using income to fund the contributions to a life policy held in trust.

Gifts for Maintenance of a Dependant

A lifetime gift of capital designed to maintain a dependant is exempt, provided payment is for:

- The maintenance of a spouse or former spouse.
- The maintenance or education of a dependent child or stepchild under the age of 18 (or over 18 if in full-time education).
- Reasonable provision for the care or maintenance of a dependent relative who is unable to maintain him or herself due to disability or infirmity.

Gifts in consideration of marriage or registration of civil partnership

Parents can each give up to £5,000 to both parties of the marriage/civil partnership. In addition, the grandparents may each give a sum of up to £2,500. Anyone else may give £1,000.

Gifts to recognised UK charities and other bodies

Gifts to charities, political parties or gifts for the public benefit, eg universities, national museums, the National Trust etc are also exempt.

Potentially exempt transfers

Despite the changes introduced by the Finance Act 2006, it is still possible to make transfers which are PETs, including:

- Outright gift to an individual
- Transfer into a bare trust (SJP Absolute Trust)
- Transfer into a disabled trust.

No tax will be payable when the gift is made since it is treated as exempt and remains so, provided the donor survives at least seven years following the date of the gift. Should death occur between years three and seven, IHT may become payable, but at a tapered rate – see page 10. In all cases, however, any increases in value from the date of the gift will be free from IHT.

Chargeable lifetime transfers

CLTs are transfers that do not qualify as being exempt or potentially exempt, the most common example being a gift into a trust (excluding bare trusts). Although chargeable, tax will only become due at a rate of 20% (25% where met by the settlor) where the value of the transfer, when added to other CLTs in the previous seven years, exceeds the nil rate band and any available exemptions. So, for example, on a gift of £350,000 to a discretionary trust (assuming the annual exemption has been used elsewhere), provided no similar transfers had been made in the preceding seven years, the tax charge, if paid by the trustees, would be:

£325,000 at 0% = 0

£25,000 at 20% = £5,000

Gifts and trusts

If you wish to make a gift to a minor or someone you do not believe is sufficiently responsible, you may wish to make the gift but keep control over it, either until the beneficiary reaches a certain age or until you decide that the recipient is sufficiently mature. This can be achieved by using a suitable trust. Further reasons for using a trust would include:

- Provision of monies for successive generations.
- Preservation of monies which may be diluted due to divorce, dissolution or bankruptcy.
- Income Tax and/or Capital Gains Tax (CGT) mitigation.
- Mitigation of IHT.
- Avoidance of delays in obtaining a Grant of Representation.

Trusts cannot be ignored as they are a fundamental part of IHT planning. They can help not only in the process of reducing or avoiding the incidence of IHT but are also commonly used in helping provide for any liability. The IHT treatment of trusts at inception, during the term of the trust period and upon distribution of any trust funds, depends on the type of trust used.

Relevant Property Regime

Most trusts, excluding bare trusts, which have been created, or added to since 22 March 2006, fall within the relevant property regime. This means that, in addition to a potential tax charge when gifting into the trust, the trust may also be subject to IHT on ten year anniversaries and on exit. The excess of the trust fund above the nil rate band on a ten year anniversary will be taxed at 6%. If the trust is below the nil rate band there will be no charge. The exit charge is a proportion of the ten year charge. It is based on the number of quarter years which have elapsed since the ten year charge and will be no more than 6%. If there is no periodic charge, there can be no exit charge. Earlier trusts which have been amended since 22 March 2006 may also fall within the relevant property regime.

Lifetime gifts

There are three important issues that must not be overlooked when considering making lifetime gifts; the ‘gift with reservation of benefit’ rules, CGT and pre-owned assets tax.

Gift with Reservation of Benefit

The gift with reservation of benefit rules apply where an individual makes a gift but continues to enjoy a benefit from that gift, for example, continuing to take an income from an investment or continuing to live in a property. The rules also apply if you make a gift into trust and do not exclude yourself from the beneficiaries. Where there is a gift with reservation, there will be no IHT savings as the asset will remain in your estate for IHT purposes.

Capital Gains Tax

A gift is a disposal for CGT purposes. When gifts are made between 'connected persons', such as parents and their children/grandchildren, the donor is treated as having received full market value. Therefore (unless the assets are exempt from CGT), if the asset has increased in value since it was acquired, a CGT liability may arise for the donor(s).

Not all assets are chargeable to CGT, for example cash, gilts and, under most circumstances, life assurance plans. In other cases, it may be possible to claim 'holdover relief', effectively deferring any CGT until a subsequent disposal by the donee. This may be beneficial where the trustees or beneficiary(ies) pay tax at a lower rate than the donor.

Hold over relief applies to transfers of:

- Business assets;
- Agricultural property; and
- Any gifts which give rise to a CLT – predominantly, gifts into trusts excluding bare trusts, unless the trust is a settlor interested trust, and this includes trusts created for the settlor's minor children.

The age of the donor should be taken into account prior to making the gift due to the interaction that exists between CGT and IHT.

Where an individual dies holding assets that stand at a gain, although those assets will form part of the estate for IHT purposes, they will not be subject to CGT. They benefit from a 'tax-free uplift' to the value which applied at the date of death – often referred to as 'rebasings'.

Clearly, if an individual had given the asset away shortly before death, they would have crystallised the CGT liability and the asset may still be in their estate for IHT purposes. The loss of potential rebasing should be considered carefully against a potential IHT saving before making a gift. It is therefore imperative to seek advice before making the gift.

Pre-owned Assets Tax

The Finance Act 2004 introduced a new income tax charge, called pre-owned assets tax (POAT) which broadly applies to the continued use of previously owned assets. This means that, where an individual disposes of an asset and continues to benefit from it, it may be subject to POAT. The charge effective from 6 April 2005, where applicable, is based on the value of the asset or, in the case of property, on its market rental value.

Reliefs

Reliefs are available on certain types of asset. Business Property Relief, Agricultural Property Relief and the relief available for woodlands have changed over the years, but remain of exceptional value. The rationale behind these substantial reliefs is to try to ensure that family businesses or partnerships do not have to be split up and sold to pay a tax liability on the death of one of the principals. There are certain conditions which need to be satisfied and it is important not to take any action that would jeopardise such reliefs.

Business Property Relief

This provides relief from IHT at rates of 100% and 50%. Reliefs are available as follows:

- Whole or part of an unincorporated business – 100%.
- Property used in a trade by a company controlled by the donor or partnership in which the donor is a partner – 50%.
- Shares in an unquoted trading company – 100% (including Alternative Investment Market shares). It is possible to make investments specifically in order to qualify for Business Property Relief after holding the investment for two years. Alternative Investment Market share portfolios and Enterprise Investment Schemes (EISs) both qualify. EISs also offer the investor the opportunity to benefit from CGT deferral and income tax relief. If this is of interest, please contact your St. James's Place Partner.
- A controlling share holding in a quoted company – 50%.

Agricultural Property Relief

Broadly, this is available at either 100% or 50%. In order to be entitled to this relief, the donor must have either occupied the property for the purpose of agriculture for at least two years before transferring it or owned it for seven years with others farming it.

Woodlands Relief

This is a special relief that applies to the growing of timber. The relief is only available on the value of the timber, with the land on which it is grown likely to benefit from Agricultural Property Relief. This relief allows the payment of IHT to be deferred until the timber has been sold.

Additional reliefs...

Taper Relief

Taper Relief may be available should the donor die within seven years of making a non exempt transfer. The relief applies where the cumulative value of non exempt transfers in the seven years prior to death exceed the prevailing nil rate band. The proportion of the full tax payable is as follows:

PERIOD BETWEEN TRANSFER AND DEATH (YEARS)	% OF TAX PAYABLE
0 – 3	100
3 – 4	80
4 – 5	60
5 – 6	40
6 – 7	20

Quick Succession Relief

As the term ‘quick succession’ implies, this relief is available to reduce the tax payable on death where the deceased received assets on which IHT was paid within the previous five years. The deduction is broadly a proportion of the original tax:

PERIOD BETWEEN TRANSFER AND DEATH (YEARS)	TAX RELIEF AS A % OF ORIGINAL TAX PAID
0 – 1	100
1 – 2	80
2 – 3	60
3 – 4	40
4 – 5	20

For example, Simon dies leaving a bequest of £150,000 to Tony. The value of Simon’s estate is such that £20,000 tax is payable out of the residue of Simon’s estate on the bequest to Tony (ie the value of the gross chargeable transfer is £170,000). Tony dies in the fourth year. In calculating the tax payable on Tony’s estate, quick succession relief is available in respect of Simon’s original bequest and is calculated as follows:

$$\frac{£150,000 \times £20,000}{£170,000} \times 40\% = £7,059$$

In this example Quick Succession Relief of £7,059 will be deducted from the tax chargeable on Tony’s estate.

Pensions

Under IHT legislation, pensions can play a considerable role in estate planning. This stems from two factors:

- Death benefits under modern pension plans are broadly exempt from IHT although a liability to periodic and exit charges can arise if you die after age 75 and have not purchased an annuity.
- Any pension income that is not needed can be gifted under the normal expenditure out of income rule (see page 5).

Although pension death benefits are exempt from IHT, if they are passed to your survivor they will form part of their estate. St. James's Place can offer solutions which allow your survivor access to your death benefits without them forming part of their estate.

Income from a pension can provide greater flexibility in respect of the rest of your assets. If you can survive comfortably on your pension, you are able to consider making lifetime gifts of some of your capital. Alternatively, the pension income itself can be extended to benefit your dependants.

Life assurance plans

There may be a number of reasons why it is not possible to reduce the size of your estate (and any potential IHT liability). Where this is the case, life assurance plans are uniquely placed to provide a tax-free cash sum to meet any liability. However, although life assurance plans provide cash on death, they may also form part of your, or your survivor's estate thereby actually increasing the IHT liability. It is therefore imperative that the policy is written into trust to avoid this.

The contributions to the life assurance plan will be transfers of value, but will usually fall within the normal expenditure out of income exemption or the annual exemption.

Where life assurance plans have already been established, but are no longer needed for their original purpose, it may be tax effective to redirect these plans by way of lifetime gifts. This could be achieved by either assigning the plans or by placing them in trust.

Either method would be classed as a gift for IHT purposes, but the value would be based on the market value of the plan or total contributions paid if greater.

Who pays the tax and when?

On death, your Personal Representatives are liable for any IHT, which is normally due six months after the end of the month in which death occurs. Usually, the IHT liability must be met before a Grant of Representation can be issued. This can often mean that the Personal Representatives have to take out a loan to pay the tax.

Where IHT becomes due as a result of a PET becoming chargeable (where a donor did not survive seven years) it is either the recipient of the gift or the trustees (if the gift was placed into a trust) who is liable for the tax.

For CLTs, IHT is due six months after the transfer unless the transfer was between 6 April and 30 September when the tax will not be due until the end of the following April.

What can I do to reduce my IHT liability?

A number of strategies can be used to reduce the size of your estate for IHT purposes. In addition or alternatively, you or your family could create a tax efficient fund to meet any liability.

IHT and your priorities

Before any planning is undertaken, there are some fundamental considerations that should be incorporated into your strategy:

Be realistic

This cannot be over emphasised. Do not put tax savings as your prime motivation. IHT planning is about passing the proceeds of an estate to chosen beneficiaries rather than to HMRC. However, this should never be at the expense of maintaining an acceptable lifestyle.

Flexibility

Make sure your arrangements are flexible as you may need to alter them in future due to changes:

- In your personal or financial circumstances
- In, or the addition of, beneficiaries
- In legislation or HMRC practice

Keep things simple

With the complexities involved with IHT, if a simple solution can be found, it will usually be the best one.

Taxation

The information in this brochure is based on our interpretation of the law and HMRC practice as at April 2009.

Taxation legislation and HMRC practice may be subject to unforeseen changes in the future.