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Inheritance tax planning

It has often been said that inheritance tax (IHT) is a voluntary tax as action can be taken by individuals before death to reduce or eliminate IHT liabilities on death. However the need for assets and income in retirement limits the giving of gifts during lifetime. In this Briefing we consider some points to consider to reduce the amount of IHT payable on death.

What is a chargeable estate on death?

When a person dies, IHT becomes due on their 'estate'. IHT can also fall due on some lifetime gifts but most are exempt providing the donor survives for seven years after the gift. The rate of tax on death is 40% and 20% on lifetime transfers where chargeable. For 2017/18 the first £325,000 chargeable to IHT is at 0% and this is known as the nil rate band.

Within the above paragraph lie some basic techniques of IHT planning:

- are there assets which are not in my estate at death?
- to what extent can I make lifetime gifts without prejudicing my standard of living?
- can I make efficient use of the nil rate band?

Special considerations for married couples and civil partners

For many individuals, there will be an overriding desire to ensure their spouse or civil partner is financially secure after their death. The IHT system facilitates this need.

Lifetime gifts and transfers on death between spouses and civil partners are generally free from IHT. It therefore may be desirable to use this exemption to transfer assets in lifetime to ensure that both individuals can make full use of other lifetime exemptions and the nil rate bands available on death. This exemption does not apply to unmarried cohabiting couples.

If an individual needs to bequeath most of their assets to their spouse or civil partner, the nil rate band may not be utilised. Ten years ago, a special rule was introduced – the transferable nil rate band. A surviving spouse or civil partner will be able to use their own nil rate band and in addition the same proportion of a second nil rate band that corresponds to the proportion unused on the first death.

Example

On the death of the first spouse 50% of the nil rate band was unused. The estate of the second spouse would have 150% (own plus 50% from spouse) of the nil rate band existing at the second spouse's death.

Assets which are effectively not in the estate at death

Pensions

Pension funds are typically held in trust and unused funds can be passed directly to beneficiaries free of IHT in most cases. A 'nomination' form should be completed detailing the beneficiaries. Prior to April 2015, income tax charges of up to 55% could apply for individuals who died with unused funds on death. Now such lump sum payments on death are mainly only subject to:

- special tax charges to the extent that the pension funds of the deceased exceed their 'lifetime allowance' (broadly funds exceed £1 million)
- income tax if the death occurs after age 75 but the income tax is chargeable on beneficiaries at their marginal tax rate as and when they access the funds.

Thus a key part of IHT planning is to consider using the facility to pass on pension funds free of IHT to any nominated beneficiary.

Please contact us if you would like more details on the tax treatment of pension funds on death and the effect on beneficiaries.

Reliefs

Some assets which are included in the estate are effectively removed from the estate because of a 100% relief. The main example is Business Property relief. Shares in an unquoted trading company potentially qualify and therefore many shares listed on the Alternative Investment Market can qualify.

Making lifetime gifts

Many lifetime gifts will be classified as 'potentially exempt transfers' (PETs). IHT is only due if the donor dies within seven years of making the gift. An alternative way of looking at this is that they are potentially chargeable until seven years has passed. The primary example of a PET is a gift to another individual.

Certain lifetime gifts are exempt from IHT which means they are ignored even if the donor dies within seven years. Many of these exemptions are quite a low value, for example, there is an annual exemption of £3,000 for gifts to an individual. Gifts to registered charities are exempt without limit provided that the gift becomes the property of the charity or is held for charitable purposes.

Topping up the nil rate band - the residence nil rate band

From 6th April 2017, an additional nil rate band is introduced for each individual to enable a 'family home' to be passed wholly or partially tax free on death to direct descendants such as a child, grandchild or their spouses. A step-child, adopted child or fostered child is regarded as a direct descendant.

The 'residence nil rate band' (RNRB) is £100,000 for deaths in 2017/18, rising to £125,000 in 2018/19, £150,000 in 2019/20, and £175,000 in 2020/21. It is then set to increase in line with the Consumer Price Index from 2021/22 onwards.

The additional band can only be used in respect of one residential property which does not have to be the main family home but must at some point have been a residence of the deceased.

Whilst an additional relief is to be welcomed, planning to take advantage of the relief makes IHT even more complex. This is particularly so if any of the following apply:

- individuals want their share in the property to pass to a surviving spouse or civil partner
- an individual wants to downsize or cease to own the main residence
- the total estate is expected to be in excess of £2 million.

For the first two items, special provisions are contained within the RNRB rules so that the RNRB is not lost.

Effect of RNRB on spouses

Individuals who want their share in the property to pass to a surviving spouse or civil partner will not utilise the RNRB. Any unused RNRB will then be available to the surviving partner. The amount transferred is expressed as a percentage of the amount unused at the first death in a similar way as it is for the main nil rate band.

It doesn't matter when the first of the couple died, even if the death occurred before the RNRB was available.

Downsize or ceasing to own a residence

A special relief – downsizing relief - is available to individuals who:

- downsize with the result that they will probably be passing a residence of a lower value to their direct descendants on death
- cease to own a residence and move into, for example, rented 'later living' accommodation.

The RNRB will be available when a person downsizes or ceases to own a home on or after 8 July 2015 where assets of an equivalent value, up to the value of the RNRB, are passed on death to direct descendants.

Effect of total estate being above £2 million

If the net value of a death estate (after deducting liabilities but before reliefs and exemptions) is over £2 million, the RNRB is reduced by £1 for every £2 that the amount exceeds the £2 million taper threshold. For 2017/18 this means that a person with an estate of more than £2.2 million will not benefit. By 2020/21 the limit will be £2.35 million. For spouses it applies on each death estate calculation. This reduction only applies where the estate at death exceeds the limit. It does not include lifetime gifts within seven years of death.

Making efficient use of nil rate bands

From April 2017 an individual who is not married or in a civil partnership has two nil rate bands to consider. The standard nil rate band has remained at £325,000 since April 2009 and is set to remain frozen at this amount until April 2021. From April 2020 that figure increases to £500,000 if the RNRB is used. Wills need to be reviewed to check that the residence is a qualifying residence and is bequeathed to the correct beneficiaries. If downsizing is contemplated, special care is needed to include provisions in a will which will satisfy the conditions of obtaining the additional band.

For married couples and civil partners we have four nil rate bands to consider. If all assets of the married couples or civil partners need to be retained until the death of the surviving partner, the nil rate band of the surviving partner increases to £650,000 and from April 2020 the use of the RNRB provides a total nil rate band of £1 million.

If some assets can be given away to the next generation on the first death, it may be better for the first deceased spouse or civil partner to do so in order to utilise part or all of the nil rate bands available.

Relevant considerations for assets other than a residence include:

- beneficiaries will have assets at a period in their lives when they have higher outgoings
- if beneficiaries do not have an immediate need for the assets but will invest them, the future capital growth in those investments will be protected from the additional IHT that could arise on the death of the surviving spouse or civil partner.

Planning considerations for a main residence will often be more problematical especially where each spouse has an estate of more than £1 million. From a non-tax perspective, it may be preferable for the surviving person to own the property but that may result in a loss of the RNRB as the surviving spouse may have assets well over £2 million on their death. If a share in the property passes to direct relatives on the first death, the RNRB will be available on the first death and may be available on the second death.

There are also capital gains tax (CGT) considerations. Assets passing on death are acquired by beneficiaries at their market value and no CGT is payable by the estate. Once in the beneficiaries' estates, accruing gains are potentially subject to CGT if a disposal is made of the assets.

What is the best course to take in any particular will depend on a wide range of factors and there will often be no 'right' answer. But it is better to have considered the advantages and disadvantages of different strategies and writing wills with the relevant considerations in mind. Do please talk to us if you would like more information or advice on any matters raised in this briefing.