

## ***Inheritance Tax (IHT) – 2008/09***

Inheritance Tax is a cumulative tax applying to transfers during life and on death. It is payable on transfers in excess of the nil rate band, which currently amounts to £312,000.

### **Inheritance Tax Rates**

<b>Taxable transfer</b>	<b>Rate %</b>
Up to £312,000	Nil
Over £312,000	40

Transfers above the nil rate band allowance of £312,000 into discretionary trusts are charged at 20%.

### **Taper relief on gifts**

<b>Years before death</b>	<b>Percentage of death rates</b>
0-3	100
3-4	80
4-5	60
5-6	40
6-7	20

### **Exemptions**

#### **Spouse exemption**

Transfers during lifetime, or at death, between husband and wife are completely exempt from tax, unless the recipient spouse is domiciled outside the UK. In this case, exemption is limited to transfers up to £55,000.

The exemption applies, even if the spouse benefits under a life or other limited interest under a settlement. The exemption is not excluded merely because the gift is dependent upon the recipient surviving the other spouse for a specified period, provided that this period is not longer than six months.

Legislation has recently been introduced to allow a claim to be made to transfer any unused IHT nil rate band on a person's death to the estate of their surviving spouse or civil partner who dies on or after 9 October 2007. This applies where the IHT nil-rate band of the first deceased spouse or civil partner is not fully used in calculating the IHT liability of their estate. When the surviving spouse or civil partner dies, the unused amount may be added to their own nil-rate band.

For example:-

- On the first death none of the original nil-rate band was used because the entire estate was left to a surviving spouse. If the nil-rate band when the surviving spouse dies is £350,000 then this would be increased by 100% to £700,000.

- If on the first death the chargeable estate is £150,000 and the nil-rate band is £300,000, then 50% of the original nil-rate band would be unused. If the nil-rate band when the surviving spouse dies is £350,000, then that nil-rate band would be increased by 50% to £525,000.

### **Annual exemption**

The first £3,000 of transfers in any one tax year by any one donor is exempt. Any part of this exemption not used can be carried forward to the following year only. However, the later year's exemption must be used completely before using the part which has been carried forward. This exemption is available for both spouses separately.

### **Small Gifts Exemption**

Lifetime gifts are exempt up to a total of £250 to any one person in a tax year. This exemption cannot be carried forward to later years and cannot be used in conjunction with another exemption.

### **Normal Expenditure out of Income**

Lifetime gifts are exempt if they are made out of the donor's income. The gifts should be made as part of normal expenditure and the donor should be left with sufficient income to maintain his or her standard of living, without resorting to capital. The capital element of an annuity bought after 12 November 1974 and withdrawals from single premium bonds are regarded as capital for this purpose.

### **Wedding Gifts**

Wedding gifts are exempt: up to £5,000 by a parent of the bride or groom; £2,500 between the bride and groom, or by their grandparents and £1,000 by anyone else.

### **Gifts to Charities and Political Parties**

Gifts to UK charities and major national political parties are totally exempt, with some exceptions where the gift is not outright, during life and on death.

### **Gifts for the National Benefit**

Certain gifts, during lifetime and on death, for the national benefit are exempt. These include gifts to museums, libraries, universities and the National Trust. Gifts of land to housing associations are also exempt.

### **Death on Active Service**

The estates of members of the armed forces are completely tax free on death, if they die because of wounds received or diseases contracted on active service.

## **Reliefs**

### **Business property relief**

Business property relief is given by reducing the taxable value of qualifying business assets. Where the relief applies, the value attributable to 'relevant business property' is reduced by:

- 100% for a sole proprietor's business, an interest in a partnership, a controlling holding of shares in a company, or a holding of shares in an unquoted company;
- 50% for land, buildings, plant or machinery owned by a controlling shareholder or partner and used in the business.

To determine control of a company, the shareholdings of both husband and wife are added together.

Generally, to qualify for the relief, the property must have been owned by the transferor for two years before the transfer and the relief will apply only to assets used wholly or mainly for the purposes of the business.

Companies or businesses dealing in securities, stocks and shares, land or buildings or making or holding investments are not eligible for relief. Companies quoted on the Alternative Investment Market are treated as unquoted companies.

### **Agricultural property relief**

Relief is available for agricultural property, where the transferor has either occupied the property for two years or owned the property for the previous seven years. Where the relief applies, the value transferred is reduced by:

- 100% where the transferor has the right to vacant possession, or the right to obtain it within 12 months or the land is valued at an amount broadly equivalent to the vacant possession value, regardless of the terms of the tenancy. Furthermore, if the transferor does not have such right but owned, or had a beneficial interest, in the property before 10 March 1981 and would have been entitled to agricultural relief had he or she disposed of the property, then the relief is available up to a limit of £250,000 or 1,000 acres, whichever is the greater.
- 100% where land is tenanted under a lease that started after 31 August 1995.
- 50% relief is available in any other case.

From 26 November 1996, land managed according to certain habitat schemes is treated as farm land; buildings used for the management of the land are treated as farm buildings and are eligible for relief.

Where agricultural relief is not available, business relief may apply if the conditions for that relief are satisfied.

If tax becomes payable because the donor dies within seven years of making the gift, these reliefs will be available only if the recipient still owns the property and it is still used for business or agricultural purposes. Relief will still be available if the original property was replaced, within 12 months, with similar property.

Similar rules apply to the reliefs if additional tax becomes due because the donor dies within seven years of making a chargeable lifetime transfer.

### **Changes to trust rules announced in budget 22 March 2006**

Major changes were announced to the inheritance tax rules for trusts, broadly bringing interest in possession and accumulation and maintenance trusts into line with the current regime for discretionary trusts.

This means that:

- Transfers to these types of trust will be treated as chargeable lifetime transfers, rather than potentially exempt transfers, so that an immediate IHT charge of 20% will be payable where the settlor's available amount of nil rate band is exceeded.
- A periodic charge of, currently, up to 6% on the value of trust assets over the nil rate band at each ten year anniversary may be payable.
- An exit charge proportionate to the periodic charge when capital leaves the trust between ten-year anniversaries may be payable.

### **Exceptions**

The proposals will not apply to trusts that are:

- Created on death by a parent for a minor child who will become absolutely entitled at age 18

- Created on death and give a life interest that cannot be altered and, on the death of the life tenant, there are beneficiaries who become absolutely entitled to the capital
- Created for the benefit of a disabled person
- Bare trusts

### **Impact on existing Accumulation and Maintenance (A&M) trusts**

The pre 22 March 2006 IHT treatment will continue where the beneficiaries will become absolutely entitled to the trust property at age 18. A&M trusts that do not satisfy this requirement have until 6 April 2008 to alter the terms of the trust to comply. If they do not, the 10 year periodic charge and exit charge will then apply. The 10 year periodic charge will be calculated by reference to the original date of the settlement.

### **Impact on existing Interest in Possession (IIP) trusts**

The pre 22 March 2006 IHT treatment will continue, provided that when the current interest in possession comes to an end, someone becomes absolutely entitled to the trust property.

If the current interest in possession comes to an end but the property remains subject to trust, this will be treated as the creation of a new trust. If this change occurs during the lifetime of the interest in possession beneficiary, this will be immediately chargeable to IHT as a lifetime gift by the beneficiary. The trust will then also be liable to the periodic and exit charges.

If the current interest in possession comes to an end on the death of the beneficiary it will form part of that person's estate and the settled property will then come within the new charging provisions as stated above.

### **Impact on Discounted Gift and Gift and Loan schemes**

If a gift is made to a Discounted Gift Trust Scheme the chargeable lifetime transfer portion is added to the accumulated chargeable lifetime transfers from the previous seven years. If the total is less than the nil rate Inheritance Tax band, currently £312,000, then there will not be any immediate tax implications. However, there is potential for periodic and exit charges throughout its existence if the chargeable lifetime transfer portion exceeds the nil rate band.

As the growth on the loan portion of a Gift and Loan scheme is considered a chargeable lifetime transfer this is potentially liable to charges.

Both these types of schemes will continue to be effective for Inheritance Tax planning and in many circumstances the changes can be managed to reduce the impact.

### **Inheritance Tax planning**

The following points outline some of the possible approaches to reducing an IHT liability:

- Wills. The importance of having a will, correctly drawn and regularly reviewed, cannot be overstated. Firstly, it ensures that the deceased's estate devolves exactly as he/she desires and in as tax efficient a manner as possible. Secondly, it simplifies the administration of the estate thereby saving time and unnecessary expense. If there is no will, then the statutory intestacy provisions will apply. This may mean the assets of the estate pass in a way which is not in accordance with the deceased's wishes.
- It is possible to alter the terms of a will after death by affecting a deed of variation (also known as a deed of family arrangement) within two years of death. The two year period is an opportunity to review all of the family's financial circumstances and in particular the needs of any surviving spouse. It is not necessary for all parties to agree to the variation, only those who are giving away an entitlement. It is also worth noting that even where a will has not been made it is still possible for those who would benefit under the intestacy rules to vary the estate in exactly

the same way. With regards to Will planning using a deed of variation should be viewed as a plan of last resort. It is possible that the availability of deeds may be withdrawn at some stage and they should not be regarded as an alternative to a well written Will.

- Make use, during lifetime, of available exemptions.
- Make potentially exempt transfers and survive seven years. Gifts made more than seven years before death are exempt from IHT.
- Create tax efficient funds which accumulate outside the estate, rather than within it. Schemes are available which offer opportunities for mitigating IHT whilst maintaining flexibility and control.
- Life policies. If an individual who has taken out a policy remains beneficially entitled to it (and thus to its proceeds) when he/she dies, those proceeds will form part of the estate for the purposes of calculating IHT. Policies can be written in trust so that the proceeds are not payable to the estate and hence are not chargeable to inheritance tax. This also has the advantage of providing readily available funds to meet any IHT liability.
- Pension plans. Where an individual has the right to nominate lump sum death benefits payable under a pension scheme, he/she can exercise that right to avoid the benefit falling into the estate thus avoiding a potential charge to IHT. Death benefits can also be made subject to a discretionary trust where required.

#### **Guidelines for Inheritance Tax planning**

- Gifting surplus assets and income is one way of reducing IHT. However, an equally effective and perhaps more enjoyable approach is to spend surplus assets and income during one's lifetime.
- Start early. If there are surplus assets to be given away, a long term programme using the annual and normal expenditure out of income exemptions can build up a significant fund and an early gift of an appreciating asset gives the recipient the benefit of the capital appreciation free of inheritance tax. The earlier a gift is made the greater is the chance of the donor surviving for seven years.
- Do not give away too much. It sounds obvious but it is often ignored. It is prudent to take into account changes that may occur - retirement, illness, nursing home fees - and external factors such as inflation or a fall in stock market prices.
- Gift the right asset. Assets with growth potential may save more IHT than cash gifts.
- Consider the effect on the recipient. It is all very well to save inheritance tax by giving away assets but that is only half the story. It is important not to overlook what it may do to the recipient. Giving young people too much too soon may not be appropriate.
- Avoid the creation of an administrative burden. Trusts may often seem an appropriate way of achieving a tax saving, but it has to be remembered that a trust once created does not look after itself. Someone has to deal with the income and investments, keep the accounts, prepare the tax returns and decide when anything needs to be done with the trust. All such matters should be fully considered.
- There are taxes other than IHT. Saving IHT is one consideration but it is necessary always to keep in mind the interaction with other taxes such as Income Tax and Capital Gains Tax. The impact on both the donor and the recipient needs to be considered.
- Flexibility and simplicity. Things can change and things can go wrong. An absolute gift once made cannot be reversed and a rigid trust once made may be unalterable. The greater the complexity the greater the chance that something will go wrong.