INHERITANCE TAX PLANNING

So what exactly is Inheritance Tax or IHT

It has rather humorously been described as a voluntary tax, due mainly to the fact that there are many ways to mitigate it that quite a lot of people make no efforts to do. The Inland Revenue raise in excess of £2,000,000,000 per annum yes that was £2 billion.

The tax is essentially potentially due on monies past onto beneficiaries other than the spouse.

It is little known that there are two levels at the moment people think there is only one but there is not there are indeed two. The first one is £0 to £325,000 (rates for tax year 2015-2016) this is currently zero rated. This is one of the levels because whilst extremely unlikely the government is always able to raise this level from zero to actually generate revenue.

The next level is over £325,000 and this level and beyond is taxed at 40%. So any money over and above £325,000 is potentially taxable at a rate of 40%.

You will here talk throughout this document of the word potentially, it is important to understand that IHT is always potential, potentially it is due and potentially it may not be due. With careful planning the potential can be reduced in quite a lot of cases down to nothing.

So to summarise inheritance tax is a tax on your estate when it is passed onto your beneficiaries. It is taxed at a rate of 40% on any amount over £325,000. So an example of a total estate passed onto beneficiaries worth £425,000 with a single allowance would attract a tax of £40,000.

Spouse threshold transfer

In October 2007 the Treasury announced a change in the rules governing the nil rate band, or 0% rated threshold, which every individual qualifies for. The change centred on the ability to transfer the threshold from one spouse to another after death.

The reason for this change is spouses can and do transfer their estates to each other on death completely free of any inheritance tax. This is great but as a result it does essentially waste the nil rate band which they qualify for.

So the government announced that they would allow any unused nil rate band to be transferred to the surviving spouse to be used on their death giving potentially a total nil rate band of £650,000 (based on 2009-2010 rules)

The only thing to pay particular attention to is the fact of the "unused amount". So if say for example some of the estate was passed to someone other than the spouse at the time of the first death a percentage of the nil rate band could have been used up then so the surviving spouse would only qualify for the percentage remaining of the nil rate band on their death.

There is a claim form to submit to the inland revenue stating what is available and what is being claimed for and this will tell you what you will qualify for at that time.

Inheritance Tax exemptions

It is worth noting that there is a difference between IHT exemptions and IHT reliefs. Exemptions tend to be on payments made and transfers made. Whereas reliefs are normally applied to assets themselves such as business relief etc.

The main exemptions to know about are as follows:-

Spousal exemption

The most common exemption and also the most commonly used exemption is the between spouses. Any assets that transfer between husband and wife or officially recorded civil partners is completely free of any inheritance tax. These transfers also take place without using up any of the nil rate band which is why it is transferable under the Spouses threshold transfer.

Debts and liabilities against estate

This is not really an exemption in the true sense of the word but the fact is you don't pay tax as a result of it. Basically the revenue allows you to deduct any and all debts against the estate prior to calculating any inheritance tax liability.

Annual exemption

Everyone has an annual exemption to the value of £3,000. This amount can be carried forward a year but only one year if it is not use then it expires. So technically you could give away £6,000 in one year if you had not used it the year previous. Then the following year you would have a further £3,000 exemption to use.

Gifts

There are certain gifts that are exempt from inheritance tax over and above the annual exemption of £3,000. Due to the fact that there is a few of these we have devoted a page to them that can be found by clicking on the box below marked GIFTS.

Regular Gifts

This is also covered in the section marked Gifts below.

Exempt Beneficiaries

It is worth knowing that some beneficiaries themselves are exempt. So any payment to them will just reduce your estate for inheritance tax purposes. They are as follows:-
The obvious one your husband/wife or civil partner.
Any UK registered charity
Some national organisations such as National Trust, Universities, and Museums
And finally United kingdom registered political parties.

Inheritance Tax and the 7 Year rule

There is a way that you can give your whole estate away and pay no tax at all. This way has been a managed way of passing large estates down the generations by wealthy families for centuries. This type of transfer is known as a "Potentially Exempt Transfer" or a PET.

In short, wealthy families who have large estates would plan to pass the whole estate onto one or two heirs, typically eldest son or daughter. This would normally take place when the son or daughter was over twenty one.

Now as long as the parents survived a period of 7 years there would be no tax whatsoever due on that part of the gifted estate. This rule is known as Taper relief.

It is important to bear in mind that when making a large gift it has to be in excess of the nil rate band to benefit from any potential reduction in the potential tax due as a result of the taper relief..

In addition it is also important to be aware that any gift made essentially uses up the nil rate band and could push the remaining estate into a full rate of tax with no relief at all for the subsequent 7 years.

So for example if you use the figure of £320,000 as a guide for the nil rate band and you pass £400,000 over as a gift then £320,000 of that amount will be taxed at nil rate and £80,000 will potentially be taxed at the rate calculated below depending on when death occurs after the gift is made.

However if there is any money left in the estate this will now be taxed in full for the next 7 years as the nil rate band has been passed with the gift.

It has to be said it is very complicated and this is why you need a specialist to assist you in effectively planning for it correctly.

That said if the individual making the gift dies during the 7 years and the gift was sufficient to exhaust the nil rate band tax should be due according to the calculation below :-

If death occurs within the first 3 years after the transfer there will be 100% of the tax due.

If death occurs between years 3 and 4 then only 80% of the tax will be due

If death occurs between years 4 and 5 then only 60% of the tax will be due

If death occurs between years 5 and 6 then only 40% of the tax will be due

Finally if death occurs between years 6 and 7 only 20% of the tax would be due.

So in summary the tax is still 40% but depending on the year of death after the transfer is made anything from 100% of that 40% to 20% of the 40% may be due, and then obviously if you survive the 7 years then no tax is due at all.

Do not think for one minute that you have to be a wealthy land owner to benefit from the 7 year rule because you don't all you have to have is an estate that carries a potential tax bill and the rest is just good tax planning.

Inheritance Tax relief's

Having given your maximum allowances in gifts and qualifiable exemptions the only thing for you to know now is whether or not your estate qualifies for any of the inheritance tax relief's available under the system.

There are a few reliefs available but the two main areas of relief are as follows:-

Business relief

This is quite a complex relief and some things qualify whilst others don't but in simple terms it allows you to pass on business assets without the payment of IHT it includes such things as property buildings shares and machinery. Depending on what it is exactly that is being transferred it can qualify from between 50% and 100% tax relief.

Agricultural relief

This one is much more simple it is attributed to agricultural property such as farms etc. It includes farmland and buildings and property but does not include machinery. That said the machinery may qualify for business relief so it is worth checking with the revenue on that one.

Please note that any relief is complicated and may also be somewhat subjective, so it is well worth ensuring that you seek good advice before making any lasting decision regarding your IHT liability. For a free no obligation chat with one of our specialists please click on the contact button at the top of this page.

Life insurance for inheritance tax planning

It has to be said that life insurance as a solution for inheritance tax planning is the place of last resort.

A lot of advisers fail to point that out owing to the fact that they get commission for selling life insurance and the fact that a lot of financial advisers lack the experience in the IHT market to actually solve the problem without resorting to life cover.

That said there is still a place for life cover but only, as I have said, as a last resort.

This site and all our advisers will aim to mitigate the majority of IHT liability but when all that can be done has been done there is still the option of just covering the liability left and that will then pay of the tax when due, ensuring that the estate remains intact for your beneficiaries.

There are essentially two types of life insurance policies associated with inheritance tax planning.

Policy type one - Gift inter Vivos -
This policy is designed to cover the tax liability associated with PETs potentially exempt transfers (The 7 year rule). This policy is designed to reduce at exactly the same rate as the tax reduces after the PET has been made. So there is a 100% cover years 0 to 3, 80% year 3 to 4, 60% year 4 to 5, 40% year 5 to 6, and then 20% cover year 6 to 7.

The second and far more common type is standard life cover. Standard life insurance is ideally written on a whole of life basis but if cost is an issue you can take out a long term, term insurance plan. The only problem with the latter is the plan will finish at some point in the future and if that is before death you will not have any life insurance and no cover to repay the IHT bill on death. So you can see that the whole of life insurance plan is by far the best option.

When arranging any life insurance for IHT coverage you need to establish the level of the IHT liability and aim to have cover at that level. It is always worth considering indexing the sum assured to ensure the value of the cover rises with inflation as the likelihood in most cases the estate itself will also rise with inflation and in turn the IHT bill itself.

Please note that HM Revenue and Customs practice and the law relating to taxation are complex and subject to individual circumstances and changes which cannot be foreseen.