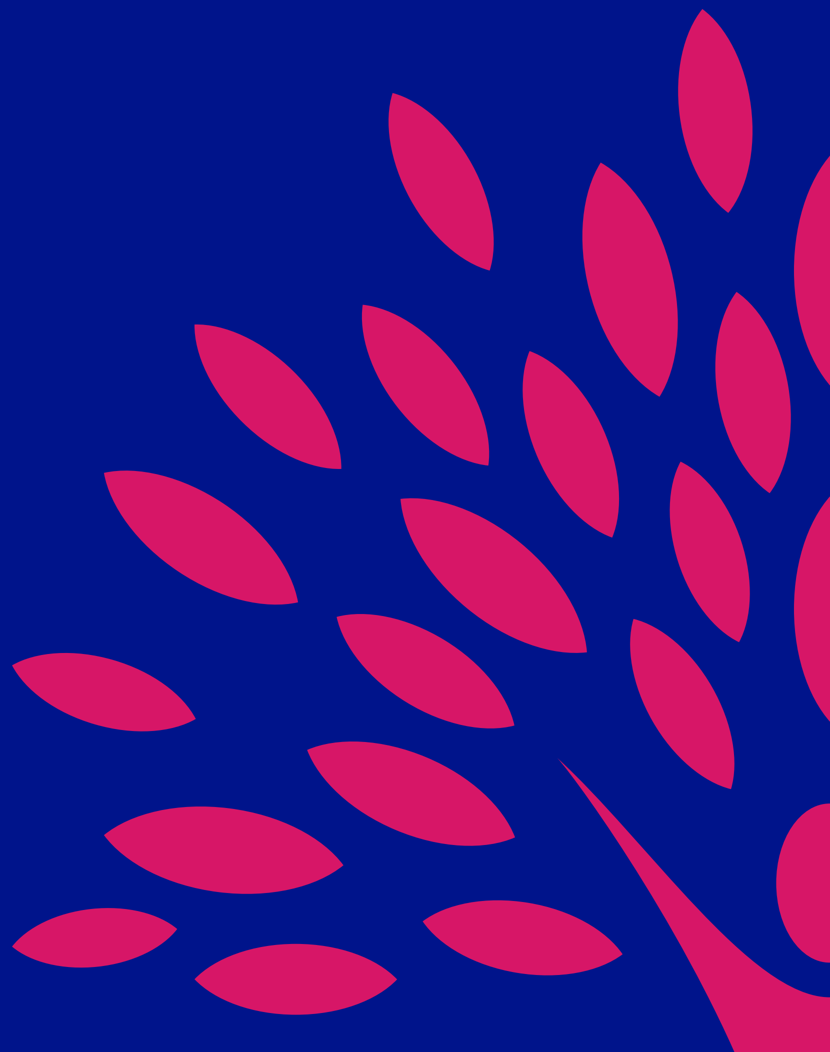
Our guide to inheritance tax and estate planning



Tax, tax… and more tax

In all likelihood, you will have worked hard to build up your current wealth. You may have taken risks, devoted long hours to creating a business or made sacrifices to establish your investment portfolio.

At all stages, you will probably have suffered considerable amounts of tax, be it income tax, corporation tax, capital gains tax or stamp duty land tax.

And then there's inheritance tax (IHT) – potentially the final taxing cut.

Inheritance tax was introduced by the Inheritance Tax Act 1984, which came into effect in 1986 but which has its roots in Estate Duty, which was first introduced in 1894. While the majority of estates are too small to be subject to the tax, for those that are above the threshold, the average tax payable is significant – £181,000 per estate in 2014/15. In recent years, rising house prices and a frozen starting point ('threshold') for IHT have sharply increased the current and projected tax take, as the chart below shows.

But it's not all about tax…

While IHT may be a major concern for you and your heirs, there is much more to estate planning than just reducing the Chancellor's slice. Indeed, for some people IHT is a price that has to be paid to achieve their other financial goals. Either way, it is certainly worth thinking first about what you want to happen to your wealth once you are no longer around:

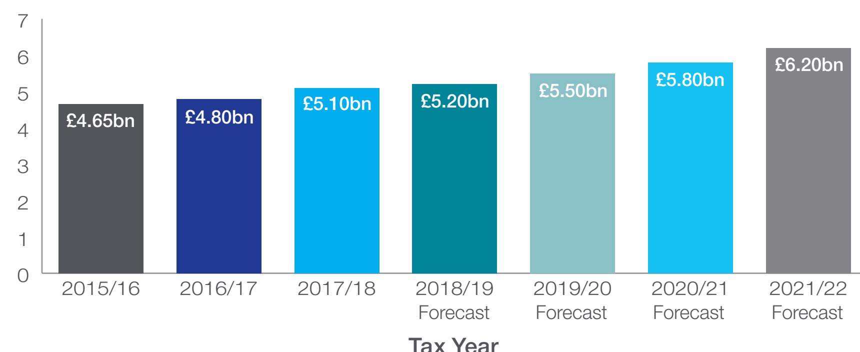
- What should any surviving spouse or partner inherit? Often the simple answer is 'everything', leaving many decisions about wealth distribution to others until second death.
- Who are your (other) chosen beneficiaries?
- Are there specific items – from jewellery to shares in a family business – you want particular people to receive?
- What framework – if any – is needed for your bequests? You might be happy to leave capital outright to a 40 year old architect daughter, but the same may not be true of a 19 year old student son.

Answers to these questions will help shape your will and provide a structure for your IHT planning. They may also prompt you to consider whether making some lifetime gifts is a sensible option.

Inheritance tax basics

As a general rule, if you are of UK origin, if you live in the UK and consider it to be your permanent home, then you are regarded as having UK domicile and your entire estate, wherever it is situated, will be subject to UK IHT. On the other hand, if you do not regard the UK as your permanent home and HMRC accept that you have a non-UK domicile, then normally you will only be subject to UK IHT on assets

The rising IHT take (£ billion)



which are situated in the UK. However, it is important to note that even if you are not legally domiciled in the UK for general purposes, you will nonetheless be deemed domiciled in the UK for tax purposes if you have lived here more than 15 out of the last 20 years. Space limitations mean that this guide only considers the UK domicile situation.

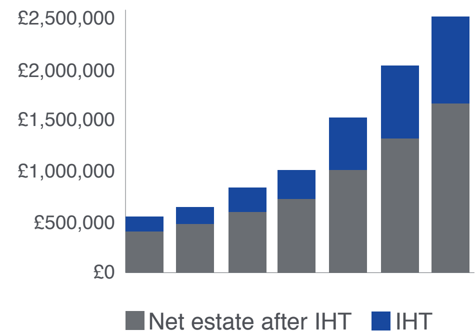
Although an IHT liability can arise during lifetime in some circumstances, in practice the vast bulk of the tax is raised at death. On death, IHT is payable at a flat rate of 40% on the amount by which your estate exceeds the nil rate band (frozen at £325,000 until April 2021). As illustrated by the graph, the amount of IHT payable increases dramatically as the size of the estate rises.

In practice, however, you may have made lifetime gifts the seven years prior to death that will use up some or all of the nil rate band – increasing the liability on your estate further still. Alternatively, there may be reliefs and exemptions to take into account that will effectively 'exempt' a greater part of your estate form IHT.

The main exemptions and reliefs that can reduce IHT are:

- **The spouse exemption:** Any amount you leave to your UK domiciled spouse/civil partner is exempt from IHT. The exemption applies to gifts made during lifetime as well as to those made in your will on your death, but there are no exemptions for unmarried couples or 'common-law' spouses.
- **Business and agricultural property relief:** If you own all or part of a trading business or a farm, you may be entitled to valuable reliefs. The rules are complex, but in outline:
  - 100% relief is available for shares you hold in unlisted trading companies (including those listed on the Alternative Investment

The Treasury's slice



Market (AIM) and similar markets), sole trader and partnership interests in a business, owner-occupied farms and tenanted farms where the lease started on or after 1 September 1995.

– 50% relief is given for property and other assets owned by you and used by a trading company that you control, or by a partnership in which you are a partner. 50% relief also applies to tenanted farmland where the lease began earlier than 1 September 1995.

These reliefs will often allow family enterprises to pass free of IHT if the appropriate conditions are met: advice is therefore vital if you think they may be relevant.

- **Taper relief:** If, unusually, you make lifetime gifts that attract tax, either when they are made, on death in the following seven years, or both; the recipients may benefit from taper relief. This relief reduces the amount of tax that would otherwise be payable at death in respect of a gift that was made more than three years before death. For instance, an outright gift made just over four years before death benefits from a tax reduction of 40%. In practice, very few people benefit from the relief because the majority of lifetime gifts are either exempt or below the nil rate band (or the donor survives for seven years). Taper relief operates by reducing the tax payable, not (as is often mistakenly believed) the value of the gift, so, if there is no tax due, taper relief is irrelevant.

Certain gifts made during your lifetime will be altogether exempt from IHT and so will fall out of your estate for IHT purposes as soon as they are made. Making lifetime gifts that qualify for an exemption, can be a simple, tax-efficient way of reducing the amount that will be subject to IHT on your death and it will therefore be important to take full advantage of these exemptions where possible:

- **Annual exemption:** You can gift up to £3,000 in total free of any IHT each tax year, a figure which has been unchanged for decades. To the extent that you have not used this exemption in the last tax year you can carry it forward and use it in the current tax year, but only once you have used the current year's exemption. Alas, it is not possible to carry the exemption forward for more than one year, but it is possible to use this exemption (including any carried forward element) as part of a larger gift.
- **Small gifts exemption:** You can make small outright gifts of up to £250 to as many people as you like, and they will all be exempt from tax. However, the exemption does not apply to gifts to anyone who in the same tax year has received a gift covered by your £3,000 annual exemption.
- **Normal expenditure gifts exemption:** If you make regular gifts out of surplus income that do not reduce your standard of living, these are exempt from IHT. This exemption can be very useful if you have surplus income, whatever the source and amount.
- **Wedding/civil partnership gifts:** If you make gifts to someone who is getting married or registering a civil partnership, these are exempt within limits based on your relationship to the parties, with a maximum of £5,000 applying if you are a parent.
- **Charitable gifts:** Any amounts you give during your lifetime or leave to a UK registered charity in your will are exempt from IHT. In addition, broadly speaking, if you leave 10% or more of your taxable estate to charity, then the IHT rate levied on your net estate is cut to 36%.

The nil rate band

While not a relief as such, the first part of the estate (currently £325,000) is charged to IHT at a nil rate, regardless of to whom it is left. In the case of a married couple or civil partners, if the nil rate band is not used on first death (perhaps, because the entire estate is left to the survivor), the unused amount can be claimed on second death under the transferable nil rate band rules. At current rates, this means that if each spouse's will leaves everything to the survivor on first death, then on second death there are two nil rate bands (total £650,000) to cover the estate before tax becomes payable.

For deaths occurring on or after 6 April 2017, there is also an additional 'residence nil rate band' (RNRB). Unlike the standard nil rate band (which is available regardless of the size and composition of the estate), the RNRB is only available to an estate where an interest in a residential property, that is or has at some point during your period of ownership been your residence, is left to one or more of your direct descendants (or their spouses) on your death. Like the standard nil rate band, to the extent that the RNRB is not used on first death, it can be claimed by the estate of the surviving spouse/civil partner on second death.

In the 2017/18 tax year, the RNRB is £100,000 for an individual (so £200,000 per married couple) and this will increase to £125,000 per individual from 6 April 2018. Thereafter, the RNRB will increase gradually by £25,000 each tax year until 6 April 2020 when it will be fully phased in. Once it is in full force a couple with a qualifying residence worth £350,000 will be able to leave £1m between them free of IHT.

Note that the RNRB is restricted where the estate exceeds £2m.

The importance of a will

Your will is a key part of your estate planning. It sets out what you want to happen after your death, dealing not only with passing on your wealth, but also with many other important aspects. In drawing up your will you need to consider:

- **Who should be your executors?** Your executors will have the responsibility to carry out ('execute') the terms of your will. Ideally you should appoint two or more executors. Think carefully before appointing a surviving spouse/ partner as an executor – particularly a sole executor – as bereavement and estate administration can be a difficult combination to cope with.

- **What powers do you wish to give your executors and trustees?** Usually wills are drafted to give maximum flexibility to executors and the trustees of any trusts the will creates. However, you can impose constraints if you wish – for example requiring trustees to consider a surviving spouse's wishes.

- **If you have minor children, who should be their guardian?** This can be a difficult question to resolve, but it needs to be addressed and agreed with your chosen nominees. Guardianship is not a responsibility to be taken lightly – it can be a long-term commitment.

- **What are your funeral wishes?** Your will can record whether you wish to be buried or cremated and, if the latter, state where you would like your ashes to be scattered.

- **Who gets what, when and how?** The distribution part of the will sets out what happens to your estate and potentially has important IHT consequences. There is plenty to consider:

  – Are there specific gifts of items you want to make?

  – How should gifts to minor children be dealt with? Normally this will involve some form of trust, at least until the child reaches 18 (16 in Scotland).

  – Do you want a surviving spouse/ partner to receive capital for them to deal with as they see fit or would you prefer to leave your assets to trust that provides them with an income, with capital passing after their death to children or grandchildren? This can be particularly relevant if you have children from a previous marriage.

  – Do you want the balance of your estate after any specific bequests and transfers to a surviving spouse/partner to pass outright to your chosen beneficiaries? It is not only minor children for whom it may be appropriate to use trusts – a trust can protect spendthrift adult children from wasting their inheritance.

  – Anything you own jointly – often your home – will usually pass automatically to the surviving joint owner(s), outside of your will (but not your IHT estate!). The exception to this is if the joint ownership takes the form of 'tenants in common', in which case your will can determine what happens to your share.

The decisions you make in your will have legal force when they take effect upon your death. Thus a poorly drafted will can create great problems for your executors and beneficiaries. A DIY will form from the local stationers may look a cheap option, but the fact you are reading this guide suggests it will probably not be appropriate in your circumstances.

Your will needs to be reviewed regularly, like any other aspect of financial planning. Your wishes may change, your circumstances may alter or there may be tax changes which need to be taken into account. If you marry, your will is usually revoked whereas, if you divorce, your will remains valid, but with your ex-spouse/partner treated as pre-deceasing you. In theory wills can be

re-written by the adult beneficiaries after your death via a deed of variation, but relying upon this route to correct errors is not to be recommended. Unsurprisingly, beneficiaries may not be willing to reduce their entitlements, even if it could mean tax-savings for others…

The consequences of no will

If you die without a will, the rules of intestacy determine how your estate will be distributed. These default rules vary depending upon in which part of the UK you are domiciled: England and Wales share the same rules, Northern Ireland's are very similar, but Scotland has a markedly different approach. To compound matters, the rules do change from time to time – indeed, major revisions have recently been made in England and Wales.

Like many other default systems, intestacy rules are a compromise. They are unlikely to replicate what you would put in your will and could create an unnecessary IHT bill. As with wills, a deed of variation could offer an escape, but if there are minor children involved any changes would need the consent of the Courts, which may not be forthcoming.

A word about lasting powers of attorney

A will deals with matters at the end of your life, but what if you are unable to handle your affairs before then as a result of mental or physical illness? One way to address this question is to set up a lasting power of attorney (LPA). Under an LPA you can appoint one or more people to act on your behalf if you become unable to make decisions or act yourself.

There are two different types of LPA:

- **Health and welfare LPA** which gives your attorney authority to make decisions about issues such as whether you need to move into care and the refusal of life-prolonging treatment.
- **Property and financial affairs LPA** which allows your attorney to deal with your personal finances, from payment of regular bills and tax affairs to the sale of your home.

Creating and registering an LPA while you are fit and healthy will ensure that complications, costs and delays are avoided should you later lose capacity. The LPA also enables you to choose who will act on your behalf in that event – instead of this being determined by the court – and provides you with the opportunity to set out any instructions and preferences that may be important to you.

Estate planning and IHT: bringing all the strands together.

In theory it is very simple: to avoid any inheritance tax you need to ensure that you have taken the appropriate steps so that on death your estate (including any non-exempt gifts made in the past seven years) is less than the available nil rate band including, where appropriate, the residence nil rate band. In reality, however, it is not always quite that straightforward:

- You do not know when you are going to die;
- You may need to make provision for your spouse/partner;
- Like most people, you are probably wary of making lifetime gifts of capital you may need in later life to cover care costs;
- Even if you can comfortably make lifetime gifts, you may not think it wise to do so while the recipients are still relatively young; and
- It may be impossible to make sufficient lifetime gifts to reduce your estate to below the threshold for inheritance tax because you need a roof over your (and your partner's) head and income from your investments.
- Estate planning is about trying to find compromises between the simple theory and the awkward reality, made the more difficult by a range of anti-avoidance provisions. An holistic approach, taking account of all of your assets, will be important in order to achieve a tax efficient but emotionally acceptable outcome.

A basic estate planning toolkit should include:

- A carefully drafted, up-to-date will that ensures maximum benefit is obtained from the nil rate band and residence nil rate band potentially available. An up-to-date, tax-efficient will is normally the cornerstone of any estate planning exercise, for the reasons explained earlier.
- **Lifetime gifts:** Lifetime gifts are favourably treated under the IHT rules, particularly outright gifts. In most instances they will attract no IHT when they are made and IHT will be avoided altogether if you survive for the following seven years. An outright gift means just that: anti-avoidance rules prevent you from retaining any interest in what you claim to gift. For example, you cannot put your holiday home in your children's name and continue to treat it as your own. Making lifetime gifts may help to keep the estate below the £2m threshold above which the residence nil rate band is reduced.
- **Trusts:** Trusts provide a way of controlling gifts by interposing a third party, the trustees, between you and your beneficiaries to deal with the gifted property in accordance with the terms of the trust that you

create. These can be as rigid or as flexible as you want.

- **Use of exemptions:** The exemptions are generally small, but their regular use can help whittle down your taxable estate. The normal expenditure gifts exemption is a good example: giving away investment income that would otherwise accumulate in your estate, is a straightforward and painless way to keep your estate within the available nil rate band and below the £2m threshold above which the RNRB is reduced.
- **Use of reliefs:** The business and agricultural reliefs are generous and you should be careful not to prejudice them if you are a business or land owner. If you do not currently fall into either ownership category, you may still be able to benefit from these reliefs by making and holding appropriate investments.
- **Packaged IHT-planning products:** Over the years trust-based structures have been developed which go some way towards allowing you to make a gift and retain the income from it, something the IHT anti-avoidance rules are designed to prevent. Many but not all, of these involve insurance products. In some cases, it may be possible to use existing investments in such structures, avoiding the tax and other consequences of sale and reinvestment.
- **Pension arrangements:** Having solid pension income in retirement will make it is that much easier for you to make lifetime gifts or take advantage of the normal expenditure gifts exemption. However, pension arrangements are about much more than just providing you with a retirement income as most will also pay out a lump sum upon death.

  While the lump sum death benefits under most pension arrangements are paid free of IHT, if paid as a lump sum to a surviving spouse they will form part of the taxable estate on second death. Consideration should therefore be given to the various options for planning to minimise the potential for IHT while ensuring access to funds for the surviving spouse. Informed advice which takes account of the recently introduced pension freedoms will be essential.
- **Life assurance:** If planning cannot eliminate all of the potential IHT liability on your estate – and usually it will not – then life assurance can be a valuable backstop. IHT is due six months after the end of the month of death and an appropriate life policy written in trust – which can pay out to your trustees without the need for probate – can help pay that bill. Otherwise your executors may need to borrow, as they will be unable to realise the assets in your estate until they have been granted probate, something that cannot happen until the IHT bill is settled.

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The value of tax reliefs depends on your individual circumstances. Tax laws can change. The Financial Conduct Authority does not regulate tax and trust advice. The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

So what now...

CBF Wealth Management provides financial planning advice which includes taking into account any tax planning opportunities that may be applicable to your individual goals. If you require specific advice on tax liabilities and treatments, then you should speak to a tax professional.

In this guide we have given you a broad outline of IHT and estate planning. There are many complexities and pitfalls which we have – for now – ignored. If, having absorbed the guide's contents, you want to develop your own estate plan, your next step is to talk to a CBF Wealth Management financial planner. We can take you on the journey from the very general in this guide to the very specific which addresses your personal goals and individual circumstances. It can be a long journey, but your beneficiaries will ultimately be thankful that you took it.

For further information or to book a consultation with a CBF Wealth Management financial planner, please call 0207 874 1190 or 0207 874 1194.

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