A Simple Guide to Inheritance Tax

Keeping your wealth within the family

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Introduction

Without proper guidance and financial support, Inheritance Tax (IHT) can cost families thousands of pounds. Although complicated to understand at first, there are various ways to avoid paying inheritance tax legally. Working with a financial adviser will ensure you make smart financial decisions and avoid paying the price in tax.

What is Inheritance tax?

Inheritance tax is a tax on the estate of someone who has died. This includes all property, possessions and money.

Following death, the executors of the Will must calculate the value of all assets and deduct any liabilities (debts). The remainder is called your “estate”, and this is the value that’s liable to inheritance tax.

Which assets are within your estate?

Generally speaking, anything of value should be included in your estate for inheritance tax purposes. If the asset is jointly owned, then your share falls into your estate.

This includes property, bank accounts, investments, shares, ISAs, antiques, jewellery, personal chattels, vehicles, life insurance (not held in trust) and gifts (made in the past 7 years). The asset value is determined to be the value at the date of death.

What assets are not in your estate?

Some assets fall outside of your estate and are therefore not subject to inheritance tax. This includes most types of pension plans, life insurance (held in trust) and trusts generally.

When someone dies, their outstanding liabilities will be repaid from their existing assets. This will reduce the value of their estate for inheritance tax.

Funeral expenses are generally allowable deductions from a person's estate for IHT purposes.

What is the 7-year rule in inheritance tax?

If you die within seven years of making a gift, some or all of the money you gifted will count towards your inheritance tax bill.

When does inheritance tax have to be paid?

Your executors need to pay the inheritance tax liability within six months following death. If they do not, they risk facing a penalty.

Residential status and IHT

If you consider the UK to be your permanent home (i.e, you are UK domiciled), IHT is payable on your worldwide assets.

If you don't consider the UK to be your permanent home, inheritance tax is usually only paid on your UK assets only. It is likely that the country you live in will also have its own rules and regulations.

What is the UK inheritance tax rate?

Currently, you will pay an inheritance tax rate of 40% on your taxable estate. However, estate values can be reduced in many situations.

To help you pay less tax and pass on more of your wealth to the people you want, this guide provides you with 9 practical steps you can take to reduce your inheritance tax liability.

We hope that this guide gives you everything you need to reduce your inheritance tax bill. However, if you want to discuss any aspect in more detail, please give us a call on 01179 902 602.


"In this world nothing
can be said to be certain,
except death and taxes"
Benjamin Franklin

How to pay less Inheritance Tax

There are a number of legal strategies to avoid inheritance tax in the UK. Here are 9 simple, time-tested ways to reduce your inheritance tax bill. These are tried-and-tested methods that can be used to avoid or reduce inheritance tax and are acceptable to HMRC.

1. Make a will

Making a will is one of the simplest and easiest ways to make sure your money goes to the people you want, for the reasons you choose.

It allows you to choose how your assets will be managed on death, allowing you to plan for and minimise your inheritance tax bill.

If you do not make a will, the government will decide how your assets are distributed (under the rules of intestacy).

This is unlikely to be the most tax-efficient method.

Control over your assets

Writing a will allows you to retain control over how your assets are dealt with to ensure your loved ones are provided for.

A will is essential if you are not married or want to allow for assets to be passed on to step-children.

Tax-efficency

Wills are a great way to put your tax affairs in order and legally shelter your assets from inheritance tax.

For example, you can use your Will to make gifts that use up your inheritance tax allowance or to set up trusts.

You can also make sure that all the available inheritance tax exemptions are used at the right time. Ensuring you don't pay more inheritance tax than you need to.

Setting up a trust in your will

When you set up a Will trust, you create a legal arrangement where you give cash, property or investments to someone else to look after them for a beneficiary.

An example of this is if you choose to set up a trust fund for your grandchildren's education costs.

On your death, any assets that are held within a trust are likely to be exempt from inheritance tax.

There are also occasions where passing assets directly to children can reduce the amount of inheritance tax paid.

Changing a will after a death

You can make changes to a Will after somebody has died. This is known as effecting a deed of variation.

This can help reduce inheritance tax, particularly where the intended beneficiary already has an inheritance tax liability.

For example, many grandparents leave their estate to their children.

However, if their children are already financially sufficient and do not require the money, it will just sit in their estate untouched.

On their death, inheritance tax may be paid on this money. This is where a deed of variation comes in. It allows you to change the intended beneficiary.
You could, for example, pass the assets straight onto the grandchildren, held in a trust until they are old enough.

This would mean that the money goes straight to the grandchildren without paying inheritance tax.

Any changes to the deceased's Will must be agreed upon by all beneficiaries who may be worse off and must take place within two years of the death.

A deed of variation is a complex arrangement, so it's wise to get legal advice to ensure this is done correctly.

If you're looking to reduce the amount of inheritance tax on your estate, speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

2. Make gifts

Gifting is an often overlooked but highly effective way of reducing the value of your estate for inheritance tax.

There are no limits on the number of gifts you can make.

Giving away assets while you are alive still requires careful financial planning.

You need to work out how much you can afford to give away whilst still ensuring that you have enough to meet your own needs.

Depending on how you structure the gift will determine how much inheritance tax is saved.

There are two forms of gifting, known as "potentially exempt transfers" and "chargeable lifetime gifts".

Potentially exempt transfers

A potentially exempt transfer is where you make an outright gift (i.e., you do not transfer money into a trust). You can make unlimited gifts in this way without any immediate inheritance tax charge.

If you survive for seven years from making the gift, it falls outside of your estate and there is no inheritance tax liability.

If you die within seven years, then some or all of the gift will be included in your estate for inheritance tax.

The amount that is subject to inheritance tax will depend when the gift was made.
If it was within 3 years, then the full amount is subject to inheritance tax.

If it was between 3 - 7 years ago, then only part of the gift is subject to inheritance tax.

Chargeable lifetime transfers

A gift that is not a potentially exempt transfer, is known as a chargeable lifetime transfer. These usually are gifts made to discretionary trusts and corporations.

You can make chargeable lifetime transfers of up to £325,000 every seven years without any immediate tax implications.

Any amount in excess of this will attract an immediate inheritance tax charge of 20%.

If death occurs within seven years, then the cumulative value of the chargeable lifetime transfers will need to be calculated.

Any amount in excess of £325,000 will attract a further inheritance tax charge of 20%.

Gifts out of income

If you receive more income than you spend, you can make a gift from your surplus income without any inheritance tax charge.

This is known as the "normal expenditure out of income exemption". The only limit is that the gift must come from income and not capital.

This will need to be structured carefully to avoid IHT.

You should document your gifts carefully, and it should be clear that your lifestyle is being funded by your usual income.

This means that you must be able to maintain your lifestyle from your income after making the gift. You cannot give away all your income and rely on your capital to fund your lifestyle instead.

Gift warnings

You may be tempted to think that you can pass on assets for less than they are worth, and this might get around the rules on inheritance tax.

Unfortunately, if you sell an asset for less than its true market value (e.g. selling a property at a discount to your child), then the discount will be treated as a gift & subject to IHT

Gifting, but not really

Many have tried to get around the inheritance tax gifting rules by 'giving away' assets.

However continue to enjoy the use of them (e.g. giving their home to a child while continuing to live there). This is known as a 'gift with reservation'.

If a gift with reservation occurs, then the gift will still be treated as part of the estate of the deceased, even if they no longer own the asset on death.

As such, inheritance tax will be paid. The only solution to the 'gift with reservation' rules is to pay the market rent on the asset after making the gift.

For example, you gift a property to your child at less than market value, but pay the market rate of rent to continue living there. This will then classify the gift as a potentially exempt transfer.

3. Use your allowances

There are various different types of allowances, exemptions and reliefs which can reduce your inheritance tax liability.

This includes the nil rate band, the residence nil rate band and annual gifting allowances.

What is the inheritance tax threshold?

You don't pay inheritance tax on the first £325,000 of assets. This is known as your "nil rate band" or your "inheritance tax threshold. It is a tax-free allowance available for everyone.

If you die and leave your assets to your spouse, they will inherit your tax-free allowance. They will then have two tax-free allowances, allowing them to gift up to £650,000 before inheritance tax is due.

What is the residential nil rate band?

The residential nil rate band (RNRB) is an extension of the nil rate band.

This provides you with an additional £175,000 tax-free allowance, however must be set against your main residence and be gifted to a direct descendent (child or grandchild).

As per the nil rate band, if you die and leave your main residence to your spouse, they will inherit your residence nil rate band. They will then have two allowances of £175,000, providing them with £350,000.

Combined, each person has an allowance of £500,000 that can be gifted without inheritance tax. Or, if you die and leave assets to your spouse, they will have an allowance of £1,000,000.

4. Use your exemptions

Certain gifts are exempt from inheritance tax altogether.

These include:

- Gifts to spouses
- Annual exemptions
- Wedding gifts
- Gifts to charities & political parties
- Small gifts

Gifts to spouses

Anything you give to your spouse during your lifetime or upon death (provided they live in the UK) is free of inheritance tax. This is just one of the many tax planning opportunities for married couples.

Annual exemption

You can legally give away £3,000 each tax year without attracting inheritance tax.

If you have not used this allowance, you can carry it forward by one tax year, allowing you to gift up to £6,000.

This allowance is per person, so if you are married, you can double this.

If you're looking to find out how to use your exemptions effectively speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

Wedding gifts

Giving cash gifts to newlyweds is a very common way to avoid inheritance tax. The level of tax relief varies depending on the relationship between the donor and those receiving the gift.

Parents and step-parents can give up to £5,000 tax-free. Grandparents can give up to £2,500, and other relatives and friends can give up to £1,000. These gifts have to be given on or shortly before the date of the wedding or civil ceremony.

Gifts to charities or political parties

There is no limit to the amount of money you can donate to charities or political parties.

Gifts to charities in your Will also reduce the inheritance tax rate to 36%, provided that 10% of the "net estate" is passed to charity.

Your "net estate" is the taxable value of your estate, after your residence/nil rate band and any debts/liabilities have been repaid.

Small gifts

Gifts of up to £250 are defined as 'small gifts'. You can make as many small gifts as you like without any inheritance tax implications.

The only condition is that the gift cannot be part of a larger gift.

5. Use business relief

Certain types of businesses and investments are eligible for "Business Relief". This allows some or all of the assets to be passed on tax-free.

Business relief

You can get business relief (previously known as business property relief) on certain types of businesses and investments.

To qualify for business relief, the deceased must have owned the qualifying assets for at least 2 out of the last 5 years before death and at the date of death.

Investments and business

Certain investments exist which allow you to buy into a scheme that qualifies for business relief.

This is useful when you want to retain control over the assets purchased (in case you need to sell at some point) but also aim to qualify for 100% relief against inheritance tax.

These schemes allow you to benefit from Inheritance Tax relief after two years, rather than to wait for 7 years if they make a gift.

These investments are typically higher risk and you should seek independent financial advice before investing.

The tax benefits on offer can be very attractive, but you need to make sure that you are comfortable with the risks.

6. Use life insurance

If you have a life insurance policy and die, your beneficiaries will receive a payout. If you haven't placed the life in trust, then inheritance tax will be due.

Your life insurance policy needs to be written 'in trust' to separate it from your estate to avoid any inheritance tax.

If done correctly, the net result is that your beneficiaries will receive your whole estate without a tax deduction.

You can either set up a 'term' assurance policy or a 'whole of life' policy.

A term assurance policy will only cover you until a specific age. If you die within the term, it will pay out. A whole of life policy will pay out when you die, irrespective of when you die.

Term assurance policies are generally lower cost, as the risk of your death occuring within the term is not guaranted.

Of course, the longer the term of the policy, the higher the cost. Generally speaking, whole of life insurance policies are higher cost, but they are guaranteed to pay out when you die.

The downside of using life insurance is the cost. It can become expensive the older you get.

The upside is that insurance provides a simple solution whilst still leaving you in full control of your assets.

7. Use trusts

A trust is effectively a separate legal entity. If you put assets into a trust, provided they meet specific requirements, they no longer belong to you.

As a result, assets in trust are not included in your estate for inheritance tax. The seven year rule however will still apply.

Using a trust provides a more sophisticated way to minimise your inheritance tax liability.

Depending on the type of trust, it allows you to retain some control over how the money is used and who benefits.

However, you should note that trusts have their own tax charges and costs, and the inheritance tax benefits may not always be worthwhile.

Before setting up a trust, you should consult with an independent financial adviser.

They can advise you on the right type of trust to meet your needs. They will determine the best type to minimise inheritance tax whilst keeping other taxes and charges to a minimum.

If you're looking to reduce the amount of inheritance tax your family might face, speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

8. Invest tax-efficiently

With careful planning and tax-efficient investing, you can effectively avoid inheritance tax altogether.

These investments tend to be more complex, that's why working with an experienced financial advisor is essential.

Business relief

Some types of investments buy shares in one or more privately-owned companies that qualify for business relief.

If you hold these shares for two years, their value on your death will qualify for business relief, making them exempt from inheritance tax.

Examples of investments that qualify for business relief include:

- Enterprise Investment Schemes
- Seed Enterprise Investment Schemes
- AIM investments

If you're looking to reduce your inheritance tax bill by using business relief, speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

Seed / Enterprise Investment Schemes (SEIS / EIS)

Investments fall outside of inheritance tax after two years, there is an income tax relief of 50% for SEIS or 30% for EIS.

Capital gains tax is deferred for 3 years allowing access to capital at any time. It's a riskier type of investment as they tend to be in smaller companies.

AIM investments

Another method of obtaining business relief is through a portfolio of diversified holdings known as an AIM portfolio.

This service provides investors with a portfolio of shares listed on the AIM index. In addition to the IHT relief, an AIM portfolio provides the potential for capital growth and dividend income.

However, if you receive any income or withdraw any capital growth then this will fall within your estate for inheritance tax.

To qualify for business relief, the portfolio must be held for two years, and the underlying companies must be deemed eligible. It is also possible to transfer an ISA to an AIM ISA to receive the above benefits tax-free.

Gift and loan trusts

A gift and loan trust plan is a flexible inheritance tax planning strategy. It provides you with a regular stream of income whilst gradually reducing the value of your estate.

You can also withdraw your money at any time.

How does a gift and loan trust work?

You establish the trust and make a gift (loan) to the trust. The gift (loan) is repayable on-demand and attracts interest. The trust then uses this loan to purchase an investment bond.

This investment bond can be used to provide regular withdrawals to you, usually at 5% per year over 20 years (making up 100% of the original investment).

Once the debt is 'repaid' via the withdrawals, the income stops, and the remaining investment growth is outside of your estate, ultimately passing to your beneficiaries.

Initially, there is no inheritance tax benefit. If you die immediately after setting up the trust, there is no tax-saving.

However, any investment growth that occurs is outside of your estate. This ensures that your inheritance tax liability does not grow over time, whilst still providing a regular income.

Importantly, you can demand repayment of the loan if you later need access to cash, providing you with control and access to the capital if needed.

Benefits of a gift and loan trust

▸ Gradual inheritance tax savings on the investment growth

▸ You retain access to the capital and can withdraw this at any time

▸ You receive a regular income each year from the investment bond tax-free

▸ On your death, the capital can be inherited by your beneficiaries immediately without waiting for probate

Discounted gift trusts

A discounted gift trust provides you with an immediate inheritance tax saving.

The inheritance tax saving will depend on your age/health and how much income you withdraw.

You will receive a regular tax-free income and retain control over who benefits from the capital.

The main downside is that you do not have access to the capital yourself.

If you're looking to reduce the amount of inheritance tax on your estate, speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

How do discounted gift schemes work?

You establish the trust and make a gift to the trust. The value of the gift is "discounted".

The discount amount will depend on your age, health and lifestyle. Any discount received will provide an immediate inheritance tax saving, even if you die within seven years.

If you survive the seven years, the total gift is outside of your estate for IHT. You are entitled to receive a regular, fixed withdrawal from the trust.

Only when you die can the other beneficiaries receive the money in the trust. If you are relatively young and in good health, you are likely to receive a more substantial inheritance tax saving.

Types of trust

When establishing a trust, there are three main types of trusts.
These are:

- Bare trust
- Discretionary trust
- Flexible trust

Bare trust

A bare trust allows you to specify who benefits from the trust. Otherwise known as an "absolute trust", the beneficiary is absolutely entitled to the money. Once set up, the beneficiary cannot be changed.

They are typically used for minors, such as children under the age of 18. For example, a grandparent may decide that they want to help their grandchild with education costs.

They can set up a bare trust that entitles their grandchild to the money at age 18, for the purpose of paying for university tuition.

The main benefit of a bare trust is that you know exactly who the money will go to and can specify what it will be used for.

The other benefit is for tax purposes, the assets are treated as if they were owned outright by the beneficiary.

This is particularly useful where the beneficiary has no other income (as is the case for most children). Often, any income or gain produced by a bare trust will be tax-free.

The downside of a bare trust is that the trust is not flexible. For example, you cannot change the beneficiary if you later decide that you want the money to go to somebody else.

Discretionary trust

A discretionary trust provides you with more control and flexibility over who receives the money and when they receive it.

It provides you with the discretion to choose the trustees (the people responsible for administering the trust) and the beneficiaries (the persons who stand to benefit).

You can change the trustees and the beneficiaries over time.

You can also set conditions for the trust, such as what the funds are used for.

For example, you may want a portion of the trust to be used to help with education costs for a child, and another portion used for their first house deposit.

The main benefit of a discretionary trust is its flexibility. If your circumstances change and you want to change the beneficiary, you can do so.

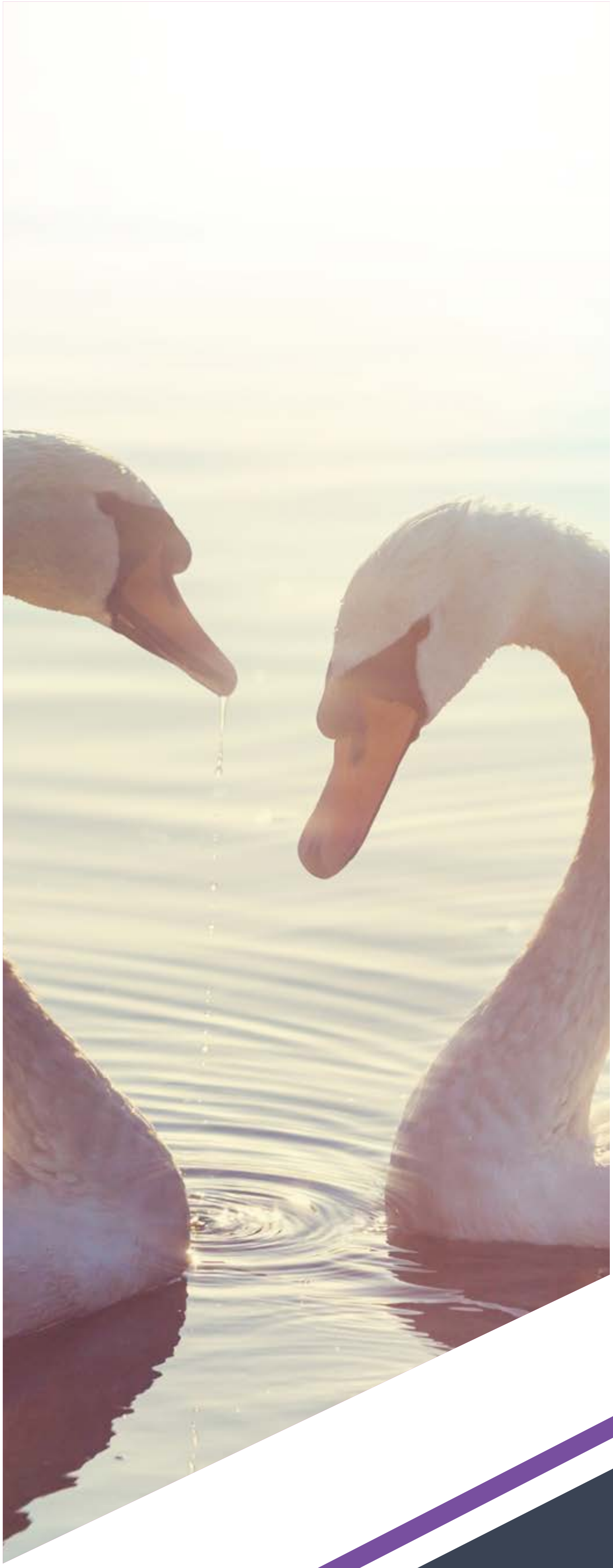
The downside of a discretionary trust is how it is taxed. Depending on the type of income and how it is structured, the trust will pay up to 45% in tax.

Flexible trust

A flexible trust or power of attorney trust specifies the principal trustee who will act on behalf of the settlor.

The trustee is in charge of giving the assets to the beneficiaries.

The trust also allows the trustee to use discretion when deciding who benefits from the capital.



Benefits of discounted gift schemes

- Immediate reduction in the value of your estate
- Full gift outside of your estate after 7 years
- Fixed, regular withdrawals for life
- Flexibility over beneficiaries
- Payment to beneficiaries without the need for probate on death

Pensions

Pensions are one of the simplest and most effective ways to reduce your inheritance tax liability.

This is because most pensions are treated as outside of your estate, meaning that they can be passed on tax-free. The inheritance tax benefits will depend on what type of pension you have.

Pension death benefits

When you die, you can nominate who you want to receive your pension. This does not have to be your spouse, you could choose for your pension to go to your children or anyone else for that matter.

In most cases, the pension death benefits are free of inheritance tax, but this may not always be the case.

This article is not a comprehensive guide but is instead intended to give you an overview of how most pensions are treated on death.

Defined benefit pensions

With a defined benefit pension, the pension income will continue paying to your spouse or civil partner at a reduced rate (typically 50%).

Some defined benefit pensions may provide an income for children and financial dependents (including non-married partners).

In addition to a regular income, some defined benefit pensions provide a one-off lump sum. Whether your beneficiaries pay tax on the lump sum will depend on how the pension has been set up.

It's important that you have completed an 'expression of wish' as this can sometimes avoid inheritance tax being charged.

Defined contribution pensions

With a defined contribution pension, there are up to three different options:

- Your pension can be paid out as a single lump sum
- Your pension can be paid as a secure income (also known as a pension annuity)
- Your pension can be inherited whilst remaining in the tax-efficient pension wrapper

Most pensions payout as a lump sum, which can result in income tax and inheritance tax charges.

General position on pension death benefits

Usually, but not always, pension death benefits are paid via some sort of trust. This means that the payment will pass outside of your Will and are usually free of inheritance tax.

However, this depends on the rules of the pension scheme. You can nominate anyone to receive your pension death benefits.

Death before age 75

If you die before age 75, then the lump sum can be made to anyone completely tax-free, provided that the death benefits are paid within two years of the member's death.

If you already have a pension annuity in payment, or your beneficiary selects a pension annuity, then any income will be taxable.

This will be charged as income tax and the rate will depend on how much other income they already receive.

If you're unsure about pension death benefits and want to discuss ways to improve your inheritance tax efficiency. speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

Death after age 75

If the pension scheme member dies after they reach age 75, then any pension death benefits are added to the recipient's income for that tax year.

The recipient will be liable to income tax between 0% and 45%, depending on the amount and their individual tax position. No inheritance tax is payable on this transaction.

A big change in 2015 is the introduction of 'beneficiary drawdown'. This allows your beneficiary to inherit the pension whilst remaining in the tax-efficient pension wrapper.

The other option is paying the pension out as a lump sum, which will be taxed in one go. The difference between the two options is provided below.

Overall, beneficiary drawdown is the most tax-efficient way to inherit a pension. However, most pensions do not yet facilitate this new tax-efficient death benefit, as it is still relatively new.

You can upgrade your pension to include beneficiary drawdown, but this may require transferring to a new pension provider.

9. Spend more

One strategy to stop your estate from getting bigger and creating a larger inheritance tax bill is to spend more.

Not only will this improve your lifestyle, this will also help you make sure that you pay less IHT as you stop your assets from growing.

However, finding the right balance between spending today and ensuring you are secure tomorrow requires a careful degree of planning.

Your overall goal should be to ensure that you reduce your inheritance tax liability, whilst ensuring you never run out of money.

Therefore, you should be careful not to deplete your assets too quickly. Having regular meetings with a financial advisor will help you get the right balance between enjoying today and being secure tomorrow.

Inheritance Tax is a complex area of financial planning. By working with an independent financial adviser, you can reduce your inheritance tax bill, increasing the amount of money received by your beneficiaries. speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

Who are we and how can we help you?

We are the Independent Financial Adviser of the Year for the South West.

We help senior professionals and business owners achieve financial security. Through long-term relationships, we ensure our clients stay on track to meet their financial goals.

We believe that financial advice is more than just about setting up a pension or investing your money to help it grow.

We believe that financial advice, delivered properly, helps clients to discover and live their best life. It's about working out what you want from life and then creating a plan to help you achieve it.

As independent financial advisers, we maintain a fiduciary standard to our clients.

We act in our clients best interests, placing them at the centre of everything we do.

What do our clients say?

"I've never been happier with my financial advisor or the advice I have received. The values of Frazer James shine through and it's the values you hold and consistently demonstrate where the customer interests are front and forward that made it easy to trust you. So glad I made the switch!"

E.J. - Council Member, Wiltshire

"I decided I needed some support with my retirement strategy. FJL have been first class in providing advice and a clear deliverable plan. The team at FJL have shown a real understanding of my priorities and needs, and provided a bespoke service with excellent communications and support. I now feel in control of my retirement plan. Big thank you to James, Chris and the team."

J.C. - Construction Director, Bristol

"The thing that struck me about Frazer James is that they were interested in me, and not my money. They took the time to find out what was important to me and what my concerns were. I'm really happy with what Frazer James are doing for me."

D.D. - Business Analyst, Oxford

If you're looking to establish a professional relationship with an independent financial advisor, speak to one of our expert advisors today on 01179 902 602 or book a consultation today.

“Someone is sitting in the shade today because someone planted a tree a long time ago”

- Warren Buffett

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financial advice, reinvented.

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