



INHERITANCE TAX



Inheritance Tax – The Optional Tax

Some people argue that inheritance tax is optional; the truth is that it isn't optional, but it is something that can be planned for. In very simple terms when we die our "estate" is assessed for its value. At that point inheritance tax may or may not be charged. Here are three tests to determine if inheritance tax (IHT) is payable.

Test 1

If the value (assets less liabilities – which is all owned property, investments etc with all debts set against this sum) of the estate exceeds the nil rate band (currently £325,000) the excess may be charged at 40%.

Test 2

If the deceased person was married and as a result of a Will all assets pass to the spouse, then inheritance tax is avoided. It is important to note that not having a valid Will may jeopardise this. If all assets pass to the spouse and nothing has been gifted in the deceased's Will, then 100% of the nil rate band (or the remaining proportion if gifting has occurred) is transferred to the surviving spouse. This is applicable to anyone that died after 9th October 2007. It does not matter when the first person died.

Test 3

On the death of the remaining spouse, the estate is assessed and depending on the nil rate band at the time and any transferred nil rate band, there may be inheritance tax to pay. The best way to explain this is to illustrate with an example.

John dies in 2011 when the nil rate band is £325,000. He is married and all his assets valued at £500,000 are passed to his wife Jill who has jointly and individually owned assets valued at the time of £400,000. Jill dies in 2012 when the nil rate band is still £325,000 at that point her entire estate is valued at £950,000. There was no debt or loans on the estate.

John & Jill's children Mark and Liz are the only and equal beneficiaries of the Will. They are advised that as John did not transfer assets or gift money 100% of his nil rate band is transferred. As a result the estate has effectively two nil rate bands (£325,000 x2 = £650,000). The estate is worth £950,000 so the excess is £950,000-£650,000 = £300,000. The inheritance tax payable to HMRC is 40% of this sum = £120,000. As a result, Mark and Liz would receive £415,000 each.

I hope that the example above illustrates how inheritance tax is calculated clearly. So let's now turn to how the tax could be planned for.



In essence there are only really a few ways to avoid inheritance tax. Very simply these are as follows:

Give It

Money given to charity is treated as though it was not part of the estate. So had John and Jill left £150,000 to their favourite charity, the estate would be worth £800,000, so the tax would reduce to £60,000 with Mark and Liz each receiving £370,000 each and the charity received £150,000.

Alternatively making financial gifts or giving assets could also remove their value from the estate, provided that John and Jill lived at least 7 years from the date that the gifts were made. This is what is known as a Potentially Exempt Transfer (PET). The main problem with this is that it means a loss of control over the assets given, which has an impact on the choices that John and Jill have and might jeopardise their ability to pay for nursing home. This could be addressed with careful and accurate planning. Any gift must be genuinely given without recourse, otherwise HMRC would deem this as a gift with reservation and it would be regarded as part of the estate.

Spend It

If John and Jill had sought financial planning advice then they may have had a clearer idea of the amount of money that they actually needed and could have spent the money more freely. This is not always possible of course as we don't tend to plan death. However, by spending money on non-assets (holidays, rentals and perhaps holidays for Mark and Liz) this would have reduced the value of the taxable estate.

Leverage It

As an estate is assessed on its net value (assets less liabilities) some people may decide to hold long-term outstanding debts. These obviously need to be serviced and great care is needed to ensure that debt is not taken out explicitly in order to avoid inheritance tax, but technically creating debt against an estate reduces its value and therefore reduces the tax.

Gamble It

Some forms of investment are so risky that an advantage is that if they are held for 2 years they would avoid inheritance tax. This would include shares held on the alternative investment market (AIM) – not something that is appropriate for most people. But had this couple had say a £200,000 AIM portfolio then all other things being equal, the estate value would reduce to £750,000 and the inheritance tax to £40,000 (40% of the £100,000 excess).

Plan It

If you are unsure about giving significant sums of money to your family – perhaps because of the very real concern about running out of money, then the most straight-forward thing to do is to simply plan to pay the tax. This involves estimating the tax bill and setting aside funds to pay for it into Trust (outside of the estate). This could be as simple as a life assurance policy or actual money. The former requires monthly or annual premiums, but these are generally relatively small given that the policy would only ever pay out once both John and Jill have died.



I would suggest that a strategy that relies upon giving, spending, borrowing and gambling is problematic and requires considerable high level care in its execution. I would also raise an overlooked yet obvious point. Most people feel that inheritance tax is essentially unfair. Whilst the UK is currently in economic difficulty, it is generally the case that the nil rate band increases each tax year and as this is a fairly political issue, could be increased dramatically. It was the last Labour Government in October 2007 that made it possible for the unused nil rate band to be transferred after suggestions that the Conservatives would raise the nil rate band to £1m. So in short, the rules may change and therefore care should be taken if you are not expecting to die for many years.

Thoughtful Thinking

Your financial planning should always reflect your wishes and values and ideally will not be a reaction to economic, legislative or political current reality. These will all change. Similarly thinking about your well being means asking some fairly difficult questions and these need to be reflected on carefully and be reflected in a valid Will that is reviewed.

3D Perspective

There is only so much that can be planned, but remember that once you gift funds or assets to others you are no longer in control. Those assets form part of the recipients' estate and is therefore part of their estate for assessment in the event of the three D's – Divorce, Debt and Death.

Plan your finances properly and thoughtfully. Arrange a meeting with me at your earliest convenience.

I want to arrange a discussion about inheritance tax.

| ACTION FORM | |
|----------------------------------|--|
| First Name | |
| Surname | |
| email: | |
| Estimated net value of my estate | |

This information will be used purely for us to provide you with a response. It will not be shared with or sold to other organisations for marketing purposes.

Further resources: <http://www.hmrc.gov.uk/inheritancetax/intro/probate-process.htm>

