

Introduction

Substantial amounts of tax could be payable on the estates of individuals who do not plan for inheritance tax (IHT). The first £325,000 for 2009/10 is taxed at a nil-rate, but the balance of the estate may be taxed at 40%. The earlier IHT planning starts, the more likely it is to reduce the eventual tax bill.

- It is important to develop a long-term strategy for IHT planning using all the reliefs and exemptions that are suitable.
- The effects of other taxes should also be taken into account, notably capital gains tax (CGT), which is now charged at a much lower rate than IHT.

The first priority for most people is to ensure that they have enough income and capital for their own needs for the rest of their lives. Only then should they consider a programme of making gifts.

- This basic planning might include making certain that their pension provision is adequate.
- For people already past retirement age, it might include reorganising investments to generate more income.

IHT planning is very individual because of the wide variety of family circumstances and personal wishes. Nevertheless, there are some broad strategies to consider.

Sharing assets

Husbands and wives (and registered civil partners) should normally consider sharing some of their assets, so that both can make gifts that will use their exemptions and nil-rate bands. This could also have advantages for income tax and CGT. There is no CGT or IHT on transfers of assets between husband and wife or between civil partners.

- It is important that the transfers are unconditional if the recipient is thinking of making gifts of these assets in the future.
- If the nil-rate band is used on the first death, it is important to adopt a strategy that does not leave the surviving partner in tax-efficient poverty. Discretionary trusts can go some way towards avoiding this, but the welfare of a surviving partner must always take precedence over tax planning.

Wills

A properly drafted will could save substantial amounts of tax. Many individuals have not made wills, or have not updated them recently. A will should be reviewed at least once every two years, and particularly after any Finance Act that includes changes to the IHT rules. This is especially important following the extensive changes in 2006 to the IHT rules for trusts and transfers to and from them, and the introduction of a right to transfer the unused portion of the nil-rate band to the estate of a surviving spouse or civil partner who dies after 8 October 2007. A will written to take advantage of old tax rules could have distressing effects and could prove expensive or impossible to correct.

- Wills may have been written in the past to leave wealth to children or grandchildren rather than the surviving spouse in order to ensure that the IHT nil-rate bands are fully utilised. This type of provision may now not be so important for tax planning purposes in the light of the ability to transfer any unused nil-rate band to the surviving spouse.

- It might be appropriate to review wills containing such provisions and assess whether some other distribution of the estate may now be more appropriate.
- There can still be a tax advantage in using the nil-rate band on the first death, if it is likely that assets passed down will appreciate in value at a greater rate than the nil-rate band will be uplifted.
- Non-tax considerations are important. For example, a person may want to ensure that their children inherit their assets. Passing all assets to a spouse or partner on the first death may not waste a nil-rate band, but if the survivor remarries, the family's wealth may never reach the intended beneficiaries.
- As far as tax is concerned, there is probably little point in passing down more than the nil-rate band on the first death because it could involve paying tax earlier than necessary. Any excess would probably be better used as a tax-free transfer to the surviving partner, who could then make a potentially exempt transfer (PET) to the next generation (if that option is still available), after assessing his or her financial circumstances.
- Careful use of discretionary trusts on the death of the first spouse can save up to £130,000 (40% x £325,000) for 2009/10 without prejudicing the access of the surviving spouse to all of the deceased partner's capital or the income it produces. A discretionary trust can also be used to allow the survivor's trustees to decide how the estate should be distributed, bearing in mind tax mitigation and the circumstances of the beneficiaries at the time.
- A will is now the only opportunity to set up a tax-efficient trust for children under 18, similar to the old accumulation and maintenance (A&M) trust.
- Even if a will has not been drawn up in the most tax-efficient way, the beneficiaries might be able to agree on a 'deed of variation' within two years after the death. However, this is not always possible and several conditions must be met. In addition, it is not effective for all tax purposes.

A properly drafted will is always recommended.

PETs

Tax can be saved if individuals can afford to make gifts of substantial amounts to their families.

- It is important to consider any CGT consequences of gifts.
- By covering the possible IHT liability on a PET with a seven-year term life assurance, lifetime gifts can be made without fear of the impact of tax on a premature death.
- Several factors must be taken into account when considering possible gifts:
 - Whether the assets produce income that is needed.
 - The availability of CGT holdover relief for gifts of business interests.
 - CGT is chargeable on a gift of an asset as if the asset had been transferred at market value. If holdover relief is available, the CGT is in effect deferred until the donee disposes of the asset. However, the donee's deductible cost for CGT may be lower than if the donee had inherited the asset on the donor's death, which may increase the CGT payable.

- Whether pension provision should be maximised before making a gift of private company shares.
- The level of IHT business property relief (BPR) on gifts of such shares or other business assets.
- The changes introduced by the Finance Act 2006 have significantly reduced the scope for taking advantage of the PET rules. Lifetime transfers into trusts, other than absolute trusts, are now normally chargeable transfers, not PETs. Thus, for most practical purposes, a PET requires an outright gift, with a corresponding loss of control.

Other lifetime gifts

Substantial lifetime giving has generally focused on PETs. However, the combined effect of the nil-rate band and the seven-year cumulation rule should not be overlooked, particularly in the light of the new treatment of most gifts into trust. Theoretically, under present legislation, nil-rate band discretionary trusts could be established every seven years with no immediate and possibly no subsequent charges to IHT.

- In practice, this type of trust is well suited to those circumstances where the tax advantages of removing an asset from the estate are needed, but where the eventual beneficiary has not been chosen at the time of the transfer.
- It is tax-efficient to transfer those assets most likely to appreciate in value, because such capital appreciation is not chargeable to IHT on the donor.
- Possible examples of suitable assets include shares in a new business venture, or rented property due to fall vacant on the death of an elderly tenant.
- Where appreciating assets are put into a discretionary trust, the trust will need careful monitoring in order to take advantage of any opportunities to avoid or reduce the ten-year and exit charges.

Business assets

Care needs to be taken over planning to take advantage of the reliefs for business property and agricultural property. It could be bad planning to transfer such assets to a husband or wife, for example, because the relief could be reduced or completely lost if the recipient does not satisfy the conditions for the relief.

Problems can also be caused by the minimum period of ownership rules, including, for example, when a wife is no longer active in her husband's business.

Another occasion when such problems can occur is with the transfer of family company shares, for example, from husband to wife. This may be followed, within less than two years, by a transfer of the shares to their children, or to a trust for the next generation. If the wife died within seven years of the gift, the shares would not qualify for BPR on the subsequent transfer, because she had not owned the shares for the minimum two-year qualifying period.

Some of the other potential pitfalls or important planning considerations with business or agricultural property are as follows:

- Because BPR and agricultural property relief (APR) exist to help businesses survive by being passed on without destructive levels of taxation, any business property on which there is a binding contract for sale is not eligible for relief. A share in a partnership will not qualify for BPR if the partnership agreement states that on the death of a partner, 'the surviving

partners shall acquire the share of the deceased partner at market value'. BPR can be preserved if such a clause is replaced with an option to buy the share of a deceased partner at market value.

- Secured loans are deducted from the asset on which they are secured. So normally, a mortgage secured on business property that qualifies for relief should, where feasible, be transferred to domestic property, eg the main residence. This reduces the taxable estate and could therefore save many thousands of pounds in IHT. Such a change would not normally affect any income tax relief available for interest on a loan to buy business property.
- Some tenanted farmland would normally qualify for only the 50% level of APR, but it may qualify for relief at 100% if it was tenanted at 9 March 1981 and is still in the same ownership. Such land should only be transferred to the next generation, not to the donor's spouse, or the 100% relief will be wasted.
- BPR may be restricted or lost for non-business use of assets or resources. For example, a trading company might plough surplus profits over a long period into investments and run down the trade, perhaps as the owner approaches retirement. Such a company is shifting the balance between trading and investment, and the availability of BPR on the shares is threatened. Some restructuring may be advisable, with full consideration of the effects on other taxes. Particular care is needed where the company acquires assets for the use of the director/shareholder or persons connected with them. Professional advice and careful planning are essential.
- Assets might be used by a family company but not owned by it. For example, business premises might be owned by a controlling shareholder and let to the company. Where gifts of shares are contemplated, relief on the assets will be lost altogether if the owner loses control of the company, even though the shares kept still qualify for 100% BPR.

The 100% BPR has removed the incentive to make lifetime gifts of the family business. Business assets held at death not only benefit from the effective IHT exemption, but are passed on to the beneficiary free of CGT (with the exception of some deferred liabilities that become chargeable on death). The value of those assets becomes the beneficiary's base cost for CGT purposes, thus providing a tax-free uplift.

IHT planning is of necessity long term. Tax legislation can change. For example, the present generous reliefs for business property might not survive. Passing the family business on intact may be extremely important to owners.

There is an element of gambling in trying to anticipate future tax legislation; but there may be an element of excessive optimism in treating a benevolent IHT regime as if it will always prevail.

Exemptions

The annual exemptions are well worth using, especially for individuals who cannot afford to make more substantial lifetime capital gifts. For gifts out of income, rather than capital, one approach to obtain as much benefit as possible is to pay premiums on a life assurance policy written in trust to provide a tax-free lump sum for the chosen beneficiaries.

- Where the policy was taken out under trust before 22 March 2006, the trust is normally not subject to IHT. Premiums will generally continue to be treated as PETs.
- For policies and policy trusts, other than absolute trusts, that started after 21 March 2006:
 - Premiums are chargeable transfers (subject to the usual exemptions), and
 - The trust is subject to ten-year and exit charges. In practice, unless the value of the policy exceeds the nil-rate band, IHT will often not be payable.

The annual exemption or the gifts out of income exemption could be used to pay annual premiums of up to £2,880 (£3,600 less income tax relief at 20%, ie £720) into a personal pension for the ultimate benefit of a child. The payment benefits from income tax relief in the form of HM Revenue and Customs (HMRC) paying £720 into the pension plan (20% of a gross payment of £3,600).

The exemptions can also be used to pay up to £1,200 a year into a child trust fund for a child born after 31 August 2002. The investment grows tax-free but cannot normally be withdrawn until the child is 18, at which time it will belong to the child.

Trusts

A trust is a way of giving where the individual making the gift (the settlor) places assets with a third party (the trustees) to hold for the benefit of one or more beneficiaries. The trustees must act in accordance with a deed of trust, which will define the entitlements of the beneficiaries and various other details. Trusts are particularly relevant to IHT planning.

Their advantages include:

- They can help to make cash available where the estate is tied up during delays in obtaining probate.
- The settlor can also be a trustee, allowing some continuing control over the gift without sacrificing the IHT savings.
- Asset protection. Suitable trusts can protect family wealth from the effects of divorce, creditors or predatory step-relatives. Where intended recipients are relatively immature, a trust allows decisions to be deferred and can prevent large amounts of income or capital sums falling into their hands at an inappropriate time.

The three main types of trust now commonly used in lifetime IHT planning are:

- Bare trust.
- Interest in possession.
- Discretionary.

A fourth type of trust, the accumulation and maintenance trust, can no longer be created with its pre-22 March 2006 IHT benefits. A discretionary trust is the main alternative.

Professional advice should always be sought before selecting and establishing a trust, not only because of the effect of other taxes in addition to IHT, but also because incorrect wording of the trust deed can have disastrous tax and other consequences.

In particular, careful consideration should be given to:

- The gift with reservation rules, and
- The income tax charge on 'pre-owned assets'.

Finance Act 2006 transitional issues for trusts

The Finance Act 2006 made significant changes to the IHT treatment of trusts, some of which have a direct impact on trusts in existence before the Act and on trusts contained in wills. A number of points need review, including:

- Wills need to be reviewed where they were designed to create interest in possession or accumulation and maintenance trusts. The trust structure may need to be changed to avoid the trust becoming subject to periodic and exit charges.
- Gifts made on or after 22 March 2006 to trusts created before that date will be subject to the new IHT trust rules, although this does not normally apply to life policies placed under trust before 22 March 2006.
- There may be new opportunities for trustees to transfer assets to beneficiaries with CGT holdover relief since 6 October 2008.

This is an area where up-to-date professional advice is vital.

Capital gains tax interaction

It is important to consider the interaction between CGT and IHT. Some transactions may give rise to liability to both taxes; in other instances there may be a choice, for example, between making a lifetime gift subject to CGT or retaining assets until death, leaving them subject to IHT but not CGT. Lifetime gifts may give rise to both CGT (on the disposal) and IHT if the donor dies within seven years. This risk should be considered when planning lifetime gifts.

There are a number of important differences between the two capital taxes:

- IHT is charged on the whole value of a chargeable transfer, but there is a substantial nil-rate band.
- CGT is chargeable only on gains, broadly disposal proceeds (or market value of the asset) less original cost, reduced by various reliefs. The annual exemption is currently £10,100 (2009/10).
- IHT is charged at 40% on death and 20% for lifetime transfers, whereas CGT is charged at 18%.
- Capital gains can often be held over (see below), but there is much less scope to defer IHT.

Holdover relief

CGT is payable on gifts, but in some cases it can be postponed until the donee disposes of the asset.

This postponement is possible for:

- Gifts of business assets (eg a sole trader's assets).
- Gifts of unlisted shares in a trading company or holding company of a trading group, including shares in companies listed on the Alternative Investment Market (AIM).
- Gifts of listed shares in a trading company or group where the donor holds at least 5% of the voting rights in the company.
- Gifts of agricultural property that would qualify for APR for IHT.

- Transfers into trusts where the transfer is not a PET. This will cover most lifetime trusts, other than absolute trusts.
- Gifts of heritage property.
- Gifts to heritage maintenance funds.
- Gifts to political parties.

Life assurance

For married couples, any IHT charge normally arises when the second partner dies and leaves assets to children or others. Life assurance can play an important role in these circumstances.

- During their lifetime, the couple could set up a life insurance policy to pay out a sum assured on the second death.
- By choosing an appropriate trust, the policy proceeds can pass free of tax to the beneficiaries, providing them with a fund to pay the IHT due on the estate of the parent.

Using life policies under trust is a tried and tested mechanism for coping with estate taxes. The premiums are normally covered by exemptions, removing the complete exercise from the taxman's grasp. However, the trust (other than an absolute trust) may be subject to ten-year and exit charges if the policy has a high value and was taken out or placed in trust after 21 March 2006.

Many people find life assurance to be their best solution to IHT, because this enables them to avoid making substantial lifetime gifts or restructuring their investments.

Pensions

Pensions have two principal roles to play in IHT planning:

- The first is that pension arrangements can provide lump sum death-in-service cover that is normally free of IHT. In certain circumstances, lump sums may also be payable free of IHT when benefits are being drawn.
- The second and less obvious benefit from the IHT viewpoint is simply the pension itself. Often the reason why capital is kept until death is that the donor or spouse could not afford the potential drop in income. If adequate pension provision removes the dependence on investment income, it can free capital for lifetime giving. Because of the generous tax advantages surrounding pensions, many people regard them as the preferred method of providing retirement income.

Conclusion

IHT planning involves making important and personal decisions about your future and your family wealth. It can be a fairly complicated matter, but it is most worthwhile because substantial amounts of unnecessary tax can be saved. It is therefore always worth discussing one's financial affairs and personal preferences with a professionally qualified adviser, to obtain the right advice, tailored to individual needs and circumstances. It is also worth reviewing one's will and estate planning regularly to make sure the arrangements are not adversely affected by changes in tax law or circumstances.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.