PRIVATE CLIENT DEPARTMENT

INHERITANCE TAX EXPLAINED
(IHT)

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Introduction

Following the pre budget statement on 9 October 2007 the rules relating to Inheritance Tax (IHT) have significantly changed. This has lead to a false sense of security. People should still make wills, and regularly review the Wills they already have in place. The aim of this guide is to explain the new rules so you can assess your IHT position and ways of mitigating it.

Inheritance Tax - rates

IHT is principally a tax payable on death; but it is also payable on some lifetime transfers.

IHT is payable at the rate of 40% on the value of a deceased's estate above the Nil Rate Band Exemption (currently £312,000).

IHT is payable at the rate of 20% on the value above the Nil Rate Band Exemption on lifetime transfers into most trusts.

It is important to note that transfers between spouses are exempt from inheritance tax.

The old law

Prior to 9 October 2007, if on the first death one spouse left everything to the surviving spouse, only one Nil Rate Band Exemption was used, meaning that there was an overpayment of IHT.

The staring point for most inheritance tax planning for married couples was the equalization of estates, holding property jointly owned as tenants in common, and utilizing, as far as possible, both Nil Rate Band Exemptions. The most popular type of Will for inheritance tax planning for married couples were Discretionary Trust Wills.

The new law

As from 9 October 2007 married couples, or couples in a civil partnership have benefited from a change in the inheritance tax law – known as **'The transferable Nil Rate Band Exemption'**

If on the first death, everything is left to the survivor, upon the death of the survivor they will have their own Nil Rate Band they can pass free of IHT, as well as the unused proportion of the Nil Rate Band of the first to die.

For the current tax year, if this were to occur, the second to die would be able to pass up to £624,000 in total, to beneficiaries such as family members before IHT would be payable.

The importance of making a Will

Under the current government legislation, if you die, whilst married and with children without making a Will, your spouse will not inherit everything. Instead they will inherit everything you own in your joint names, as well as personal chattels, a statutory legacy of £125,000 and a life interest over half of the remainder of the estate. This is important to remember, as it may not prove to be the most tax efficient way of passing the estate. A Will would avoid this complicated scenario occurring.

If everything is passed to the surviving spouse they will be deemed to own everything outright. This means that they will be able to use the assets that pass to them as they wish. Should the spouse need to go into a care home, they will be assessed by the Local Authority to pay their care home fees in full until they reach a specific limit (£22,250 for 2008/09). This could significantly use up any Inheritance that was hoped to pass to future generations.

Discretionary Trust Wills

These types of Wills were the most popular type of Will for IHT planning prior to the changes in IHT legislation.

It is our view that if you have this type of Will it is not necessary to change it for the following reasons;

- This type of Will is very flexible. If on the first death circumstances are such that there is no need for a discretionary trust to be set up, the trustees can appoint the money in the trust to the surviving spouse outright. Providing this is done at least three months after the death of the first spouse but before the second anniversary of their death, this will be treated for inheritance tax purposes as if the assets had simply been left to the surviving spouse outright. Such that the spouse exemption is still available and the nil rate band exemption has not been used up.

- The money in the trust is outside of the estate of the surviving spouse so that the surviving spouse cannot give this to persons who you would not want to benefit.

- If the surviving spouse moves into residential care in the future the assets in the Trust Fund can be protected from being used to pay for the costs of their care and ensure an inheritance for your family.

- If one of the beneficiaries of the trust is affected by a marriage breakup or financial problems the money can be held on trust and distributed to them once their problems have been resolved so that the money is not included in a divorce settlement or fall into the hands of a trustee in bankruptcy.

Ways to mitigate your inheritance tax liability

If you wish to reduce your inheritance tax liability we recommend you consider the following;

Make a Will
To ensure that the transferable nil rate band exemption is available on the second death.

Discretionary Trust Wills are still recommended if;
- You have business assets or agricultural assets
- Where there are assets that are likely to grow at a faster rate than the annual increase to the IHT allowance
- Where there is a need to ensure asset protection for children of a first marriage in cases of second marriages or where family circumstances are such that it would be beneficial to ensure as much on-going flexibility as possible.

Annual Exemption
Every individual can give up to £3,000 per year free of tax.

Potentially exempt transfers
If you give more than £3,000 per year there will be no IHT payable if you survive 7 years. If you die within 7 years taper relief is available to reduce the rate of tax payable depending on the number of years survived.

Gifts out of income
You can give away surplus income free of tax providing it does not affect your standard of living and you do not top-up your income with capital.

Gifts in Contemplation of Marriage
Parents can give up to £5,000 each free of IHT, Grandparents £2,500 each and others £1,000 each free of IHT.

Small gifts
You can give up to a total value of £250 per person for any number of people free of IHT.

Charities
Gifts to Charities are exempt from IHT

Financial Advice
A financial adviser can advise on the various investments that can reduce your inheritance tax liability.

Advice can also be sought on joint life second death policies. Please note that this does not reduce your IHT liability, the aim is to ensure that the policy covers the amount of IHT payable.

Please note that advice should be sought if you are contemplating the above. This is a brief summary and there may be other ways to reduce your IHT liability depending on your personal circumstances.

If you would like to discuss the above in more detail please contact our Private Client Team:

Private Client Department
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This fact sheet deals briefly with what is a highly complex subject. It should not be taken as complete, accurate or precise.

Full legal advice should be sought wherever a legal situation arises.

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