Let's talk about Inheritance Tax

Background

The late Roy Jenkins, former home secretary, famously quipped that *"Inheritance Tax; - it is, broadly speaking; a voluntary levy paid by those who distrust their heirs more than they dislike the Inland Revenue."*

Times have moved, with the Inland Revenue being replaced by HMRC but Mr Jenkin's words still ring true, with Inheritance Tax ('IHT') receipts hitting a staggering record of £5.4bn in 2018/19. This is more than double the annual amount paid in the 2009/10 tax year, which amounted to £2.3bn. *

What is Inheritance Tax?

Inheritance Tax (IHT) is a tax due on the estate of an individual who has died. The estate includes all property, possession, investments, and money held by the individual. If the individual's total estate totals £325,000 or less, then there is normally no IHT to pay. This figure of £325,000 is known as the Nil Rate Band (NRB) and everyone is entitled to it. If you are married or in a civil partnership, you can share the NRB, passing on any unused element once you die. A married couple or those in a civil partnership can therefore potentially benefit from a joint nil rate band of £650,000.

The nil rate band has been frozen at the level of £325,000 since 2009. As the value of property and assets increase over time, so many more are caught and end up paying IHT. There was however an additional allowance introduced in April 2017 to allow a residence to be passed to a direct descendant. This is the residence nil rate band (RNRB) and is transferable to a spouse or civil partner, just like the NRB.

The RNRB started at £100,000 per person in 2017/18 and was gradually increased to the present rate of £175,000. At this point, taking into account the NRB, couples will be able to leave £1m free of IHT when they die, with anything over this amount might be liable for tax at 40%.

So, what can be taken to avoid or reduce the impact of IHT?

The first step in estate planning is to set up a will, not only to make certain that matters are dealt with in a tax-efficient way but to ensure that the deceased's wishes are carried out. Having a will means that the intestacy rules will not come into play. These intestacy rules effectively allow the law to decide what happens to the estate, which can lead to anxiety for the family and a possible immediate charge to IHT on the first death. It is also important for those who are not married and have children to consider a will, as the intestacy rules means the estate would pass to their parents, potentially exacerbating their IHT position.

Consider taking advantage of exemptions

Each year an individual is entitled to give away up to £3,000 as a gift, which is immediately exempt from IHT. Rather than waiting on death to pass on wealth, individuals can make tax-efficient use of their exemptions to gift money while alive. This can help a younger relative by perhaps topping up their pension or paying into an ISA, potentially having a transformative effect on them.

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Individuals can also gift:

- £250 to as many people as they like;
- Wedding gifts of up to £5000 from parents to their children, £2500 from grandparents and £1,000 from anyone else;
- Any size to charities or political parties, which are both tax free.

Furthermore, gifts can be given on a regular basis as long as this comes from income and does not affect quality of life. Any such amount of regular gifting is ignored for IHT.

Gifting amounts in excess of the annual allowance of £3,000 will be exempt from IHT as long as the person making the gift survives for more than 7 years. These are known as potentially exempt transfers (PETs). Where the donor of the gift dies within 7 years and the value of the gift is more than the NRB, then a taper relief applies and the tax payable reduces on a sliding scale.

Consider gifting certain assets

Should an individual hold assets that have fallen in value since being purchased (stocks and shares for example) these could be gifted without attracting capital gains tax. This would in effect crystallise a loss which can be carried forward to offset against future gains. Any increase in value of the gifted asset would then accrue in the estate of the recipient. The gift itself would be a potentially exempt transfer and therefore outside the estate should the donor survive for 7 years.

What about my pension?

Pensions are an extremely tax-efficient way to pass on wealth. If an individual dies before attaining age 75, any funds left in a money purchase pension can be paid tax free to any beneficiary. This can be in form of a lump sum or as regular payment. After age 75 any funds are paid at the beneficiary's own marginal rate of income tax. Given the tax efficiency of a pension, in retirement it may make sense to spend other investment assets first, such as ISAs and bonds and leave pension funds for as long as possible.

Don't forget life assurance

Perhaps one of the simplest ways of providing funds to pay inheritance tax is life assurance. A life assurance policy designed to pay a sum equal to the tax liability can be established, with the proceeds going into Trust, where it will be exempt from IHT. Furthermore, it will be available immediately for the beneficiaries to pay the tax without the need to wait for confirmation or probate.

Taking control

Trusts can assist in IHT planning by giving control over how assets are gifted to future generations as well as helping to reduce an IHT bill. This is an area I will explore further in my next article, along with some other options available for mitigating the effects of IHT.

*ONS: Inheritance Tax Statistics 2014-15, 28 July 2017.