eQInsight

Protecting family wealth

Top 10 Tips for Saving Inheritance Tax

“Even though it’s the one tax you’ll never pay personally, Inheritance Tax (IHT) causes more heartache than most other UK taxes. IHT is a 40% levy on your estate when you die. The timing of the payment – before any money is released from the estate – can cause real difficulties for grieving families. In extreme cases families are forced to take out loans or sell property to pay the tax.

It’s impossible to predict what the exact value of your estate will be. However, it’s worth taking the time to understand the overall position your family will be in, and planning ahead to minimise the amount of tax due.”

John Spiers
CEO, EQ Investors

Key questions to consider

Speaking to a financial planner can help you answer many common IHT questions, including:

- How much can I afford to give away?
- What is the best timing and order for my gifts?
- Should I take out insurance?
- Is it worth setting up a trust?
- Could I afford long-term care?
- Do I need to down-size?
- Is my will structured tax-efficiently?
- Are IHT-efficient investments right for me?

EQ's financial planning team are here to help: please give us a call on 020 7488 7171 for a free initial chat.

How much can you leave tax-free?

There is no tax to pay on the first £325,000 you leave to your heirs (the ‘nil-rate band’). Married couples and civil partners can leave up to double this (£650,000) IHT-free.

Even with a combined band of £650,000 many couples have found increasing house prices mean their heirs are facing a tax bill on their death. In April 2017 a new allowance came into force for residential property. This now stands at £150,000 and will increase to £175,000 in April 2020. This applies only where the family home is left to direct descendants, and will taper off for estates worth over £2 million.[1]

Using these allowances in combination, by 2020 a married couple will be able to leave up to £1 million of assets to their children or grandchildren without paying any IHT.

Making an IHT plan

Your IHT liability is 40% of the value of your worldwide assets, less debts and your nil-rate band. However, there are some assets which are exempt from IHT. These include shares in a business, property associated with a business and agricultural property.

In technical terms, IHT is a tax on the loss of value to your estate. This includes any gifts you have made in the previous seven years. If you die within seven years the amount of IHT payable on the gift can be reduced in line with the number of years since the gift was made.

If you review your situation and think there may be a tax bill for your heirs to pay, we have outlined some options to consider overleaf. Some are relatively simple, but others will probably require financial and/or legal advice.

1 The new exemption includes a provision for those downsizing to a smaller home in retirement. The additional nil rate band will be withdrawn at a rate of £1 for every £2 over the £2m threshold.

1 Make a will

Many people do not think about writing a will until later in life, but especially for those with children we recommend doing this as soon as possible.

If you do not make a will then your estate will be distributed according to the rules of intestacy. Remember that these rules do not recognise unmarried partners: if you're not married or in a civil partnership, then your partner won't receive anything from your estate (that isn't jointly owned by them) unless this is specified in your will. You should review your will if your circumstances have changed: for example, marriage can invalidate an earlier will.

You can help your family by sharing your plans with them. You may even find that they suggest something different! Setting up a Lasting Power of Attorney at the same time will ensure someone you know can deal with your affairs if you lose capacity.

EQ Tip: Plan while you are healthy

Even a person appointed under a Lasting Power of Attorney has very limited options to conduct IHT planning on your behalf. So it's doubly important to make sure that your planning is done while you are in good health.

2 Consider your pension pot alongside other assets

The pension freedom rules mean you can draw money from your pension pot as and when you need it. But IHT only applies to pensions in very rare circumstances, so it can make sense to draw on other savings or investments (which are subject to IHT) to provide you with an income first. The exception to this is the 25% tax-free lump sum: it usually makes sense to draw this before reaching age 75. Talk to a professional financial adviser to make a plan that provides both for your retirement and for your heirs.

EQ Tip: Name your pension beneficiaries

You can name who will receive your pension pot by completing an *Expression of Wishes* form with your provider. This is separate from your will, so it's important to check that it reflects your wishes.

3 Gifts from surplus income

Gifts made out of surplus income are exempt from IHT. To be eligible your gift needs to be made habitually (this doesn't necessarily mean every month or year). It also needs to be part of your 'normal expenditure', leaving you with enough income to keep up your usual standards of living.

If you don't spend all your income, and you already have enough money saved for the future, then it may make sense to give away the extra instead of building up further taxable savings from an IHT perspective. Gifts can be made to help others with known expenditure, such as education fees or mortgage repayments, or be invested for the future.

4 Make use of exemptions

There are several allowances for gifts which are automatically exempt from IHT:

- Every year you can gift £3,000. This allowance can be carried forward one tax year if unused;
- You can make unlimited small gifts of £250;
- Gifts between spouses or for the maintenance of children, ex-spouses or dependent relatives are also exempt;
- Gifts to people getting married are exempt: up to £5,000 for your child, £2,500 for your grandchild or great-grandchild, and £1,000 for anyone else.

5 Gifts of capital to an individual

This type of gift is called a 'Potentially Exempt Transfer'. The gift is potentially exempt because, providing the donor lives a further seven years, then there is no IHT to pay. However, if the donor dies within seven years there may be tax to pay by the recipient, and in addition the estate may not benefit from the nil-rate band.[2]

For a gift to be effective from an IHT perspective there cannot be any strings attached. For example, you could not give away the family home whilst continuing to live in it – without paying rent at market rates – as this would likely count as a 'gift with reservation'. It's worth noting that HMRC tend to scrutinise any transaction involving the family home

6 Gifts of capital to a trust

It's not always appropriate to make an outright gift to an individual, especially if they are under 18. Setting up a trust allows you to start the seven year clock on a gift without giving immediate access to large sums of money.

Setting up a bare trust for a minor gives them the assets for tax purposes, but the trustees retain control until the child reaches age 18. One potential drawback is that the child can demand full access once they turn 18.

Another is that parents may still need to pay tax on income generated from gifts they have given to their children:

Setting up a discretionary trust gives the trustees (which can include you) flexibility over who should benefit and when they can access the money. This allows you to provide for family members – including those yet to be born – in line with your wishes, and to protect family wealth from being spent irresponsibly. If your gift to a discretionary trust is more than £325,000 there can be an immediate tax charge. Likewise there can be tax charges every 10 years. It's best to speak to a financial planner or legal adviser before setting up a trust to ensure it meets your needs.

EQ Tip: Gifting investments to children

Children have the same personal tax allowances as adults, so there is usually no tax to pay on their investment income or capital gains. The exception is the 'parental settlement rule'. If assets given to a child generate more than £100 of income in a year, then the parent must pay the tax due on this. This rule doesn't apply to other relatives, such as grandparents. In view of this parents may choose to gift assets that rise in value over time, instead of producing an income.

7 Buying company shares

Shares in qualifying, unlisted businesses qualify for 100% Business Property Relief (BPR) provided they are held at death and for two of the preceding five years. This means there is no IHT to pay on their value. If you don't want to give away assets and you are happy to take some risk with your investments, you could consider buying shares to pass on to your beneficiaries.

Qualifying investments quoted on the Alternative Investment Market (AIM – the London Stock Exchange's market for smaller companies) qualify for BPR and can also be held within a tax-free Individual Savings Account (ISA).

The Enterprise Investment Scheme (EIS) was set up to encourage investment in small private companies that might otherwise struggle to raise capital. Investors benefit from a range of tax reliefs including up to 30% upfront income tax relief, and full IHT exemption after a two year holding period.[3]

2 For details see: https://www.gov.uk/inheritance-tax/gifts

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8 Gifts to charity

Bequests to charities and political parties are exempt from IHT. Furthermore, if you leave 10% of the net value of your estate to charity, the overall rate of IHT due on your remaining estate reduces to 36%.

The reduction only applies to gifts made through your will, not whilst you are alive. This means that a person intending to gift 4% of their estate to charity could increase this to 10% without reducing the amount left to their other beneficiaries.

9 Taking out insurance

The people administrating your estate have to pay any IHT that is due before they can sell or pass on any estate assets. A 'Whole of Life' insurance policy provides an immediate sum of money on death to help with this: the sum assured is usually equivalent to the expected IHT liability on your estate, and is paid into trust to ensure that it's never 'your' money.

These policies can be expensive to maintain over the long term. However, the premiums can be paid as gifts out of regular income (see point 4). If you have other types of life insurance plans it's usually a good idea to have their proceeds paid into trust as well, to ensure they are paid quickly and there is no IHT on the value. You should only do this if you're in good health, otherwise there could be a transfer of value for IHT purposes.

10 Equity release

Lots of people now find they are property rich but cash poor. In this scenario you could consider using a mortgage to unlock some of the value in your property. The money raised can be used for gifting or simply to support normal expenditure.

A lifetime mortgage allows you to take equity from your home in the form of a lump sum. You can choose to pay the interest monthly or it can roll up to be paid by your estate after your death. The interest rates on this type of mortgage are higher than a standard mortgage, which means the amount of rolled up interest can be significantly higher than the IHT saving. This option shouldn't be pursued without taking specialist advice.

Risk warning

The value of investments and the income derived from them can go down as well as up, so you could get back less than you originally invested. Specifically, Enterprise Investment Schemes and Alternative Investment Market listed investments should be regarded as higher risk investments, suitable only for experienced investors who are able to withstand losses.

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