John Lamb Hill Oldridge

Keep it in the family

A guide to the various reliefs available for mitigating inheritance tax

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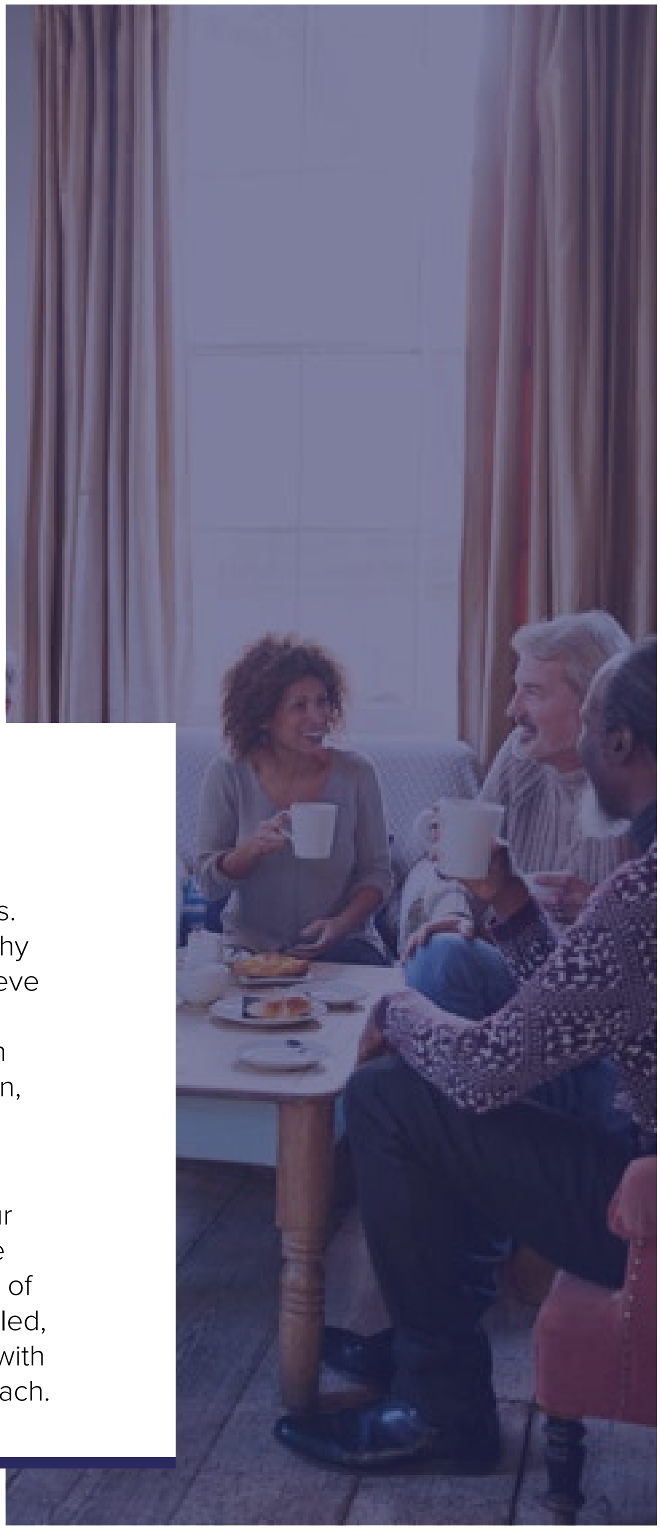
It’s good to talk

Conversations about money are rarely easy or straightforward, particularly when family is involved. That’s why inheritance is often one of the most challenging areas of financial planning, where different emotions, values and expectations collide. Yet it’s important to start talking about passing on wealth early in life so that you can begin to organise your assets before it’s too late.

Inheritance tax (IHT) planning is best approached as a continuous process. It’s a good idea to review your plan regularly to make sure it’s appropriate for your age and reflects any changes in your family, as well as the latest laws and regulations. The challenge is to strike the right balance between giving money away and retaining control so you’ll be financially secure in later life.



Flexibility and control

You might find your clients asking you about IHT when discussing other issues related to organising their assets. The rules are complicated and often change, which is why it’s always a good idea to talk to a professional. We believe that when everyone has some understating of what’s involved you can have better conversations and it’s then easier to work together to develop and implement a plan, which is why we’ve produced this guide.

At John Lamb Hill Oldridge we have the experience, expertise and market knowledge required to advise your clients about IHT and then arrange the most appropriate solutions. Our bespoke service appeals to a wide range of people who come to us for our technical skills and detailed, personal service. In many cases, we have relationships with several members of one family due largely to this approach.

Ways to pass on wealth efficiently

There's no getting away from the fact that many people leave an IHT liability on their estate after they die. Without proper planning, their families could face a significant tax bill at what is already a difficult time. Yet there are many ways to make sure you do not pay more than your fair share of IHT.

Nominating a spouse as beneficiary

Typically, IHT is levied at 40% on the portion of an estate that exceeds the threshold of £325,000. This first £325,000 of a person's estate is sometimes called the 'nil rate band', as no tax is payable on this amount.

For instance, if an estate is valued at £1,325,000, you would deduct £325,000 from this to leave £1 million that would be subject to IHT. The tax liability would then be 40% of £1 million, which is £400,000.

There is no IHT to pay if you leave your estate to a spouse or civil partner. They also 'inherit' your nil rate band, so when they die, the first £650,000 of their estate will be free from IHT.

If you leave your estate to anyone else though, this allowance doesn't apply. For example, if a married man with an estate valued at £250,000 nominates his daughter as beneficiary, then his wife would only be able to boost her tax-free allowance by £75,000 (£325,000 minus £250,000), meaning that IHT would be payable on anything over £400,000 when she dies.

You cannot pass on your tax-free allowance to an unmarried partner, regardless of how long you might have lived with them. If you leave £1,325,000 to your partner of 20 years, then an IHT liability of £400,000 applies at that stage.

In some ways, leaving your estate to a spouse might merely delay the need to pay IHT, rather than eliminate it. Consider this example:

- A woman dies and leaves her £5 million estate to her husband.
- Because the estate has been left to a spouse, there is no IHT to pay at this stage.
- The surviving husband also inherits her nil rate band, meaning that his own tax-free allowance becomes £650,000.
- However, he had an estate of £5 million in his own right, so his inheritance took the total value of £10 million.
- When he died, IHT was payable on £9,350,000 of his estate (£10 million less £650,000).
- This meant that there was still a significant IHT liability of £3,740,000 (40% of £9,350,000).

Making gifts

One of the most effective methods of reducing the eventual IHT liability is to give away cash or assets when you are still alive. These gifts are known as Potentially Exempt Transfers (PETs). Note the use of the word ‘potentially’, as gifts made in this way could still be subject to IHT.

The key issue is how long you live after making the gift. If you survive for seven years following the date of the gift, then the entire gift is exempt from IHT. If you die during the seven years following the date of the gift, then the amount of IHT payable depends on exactly when you die through a graduated system is known as ‘taper relief’:

- If you die in the first three years, IHT is payable at the full rate of 40%.
- If you die in the fourth year, IHT will be payable on 32% of the value of the gift.
- If you die in the fifth year, IHT will be payable on 24% of the value of the gift.
- If you die in the sixth year, IHT will be payable on 16% of the value of the gift.
- If you die in the seventh year, IHT will be payable on 8% of the value of the gift.

There is no limit to the number, or the amount, of gifts that can enjoy PET status, which makes it a useful way to reduce the final IHT liability on your estate.

It is important, however, to ensure you don’t give away more than you can afford, and that you retain sufficient assets during your lifetime. You also have to consider whether it’s suitable to be giving your assets to the named beneficiaries.

Exempt gifts

Certain gifts are also exempt from the taper relief regime, including:

Gifts to your spouse. You can give as much as you like to your spouse or civil partner during your lifetime, and IHT won't be payable on any of these gifts when you die. The gifts will, of course, increase the value of your partner's estate, potentially meaning that more IHT will be payable when they die.

Gifts of up to £3,000 per year. You can make gifts of up to £3,000 in any one tax year without any liability to IHT. If you don't fully use your annual allowance in one tax year, you can carry it forward for one tax year only. So, if you only gifted £1,000 in a particular tax year, your annual gift allowance for the next tax year would be £5,000.

Additional gifts of up to £250. You can give as many gifts of £250 or less to as many people as you wish, and none will be subject to IHT. The only exception to this is that you can't give a tax-free gift of this type to anyone who has already received a £3,000 gift under your annual gift allowance.

Wedding gifts. If you make a gift of £5,000 or less to one of your children when they get married, then no IHT is payable on the amount. The same applies to a wedding gift of £2,500 or less to a grandchild or great grandchild, and a gift of £1,000 or less to anyone else. To be free from tax, the gifts must be made before the wedding, and the wedding must then go ahead.

Gifts to registered charities. The definition of 'charity' here is quite wide, so in addition to large organisations you might be able to assist a community group or a museum that has a special place in your heart.

Gifts from surplus income. If you have more income than you need to maintain your standard of living, then you might choose to give some of it to your loved ones. For example, you could pay a regular sum into a child's or grandchild's savings account or assist with their school fees. To make sure the IHT exemption applies here, these gifts need to be made on a regular basis. It also helps to make comprehensive records of gifts of this type, and to provide evidence that they really are being made from surplus income.

Passing on a property to children

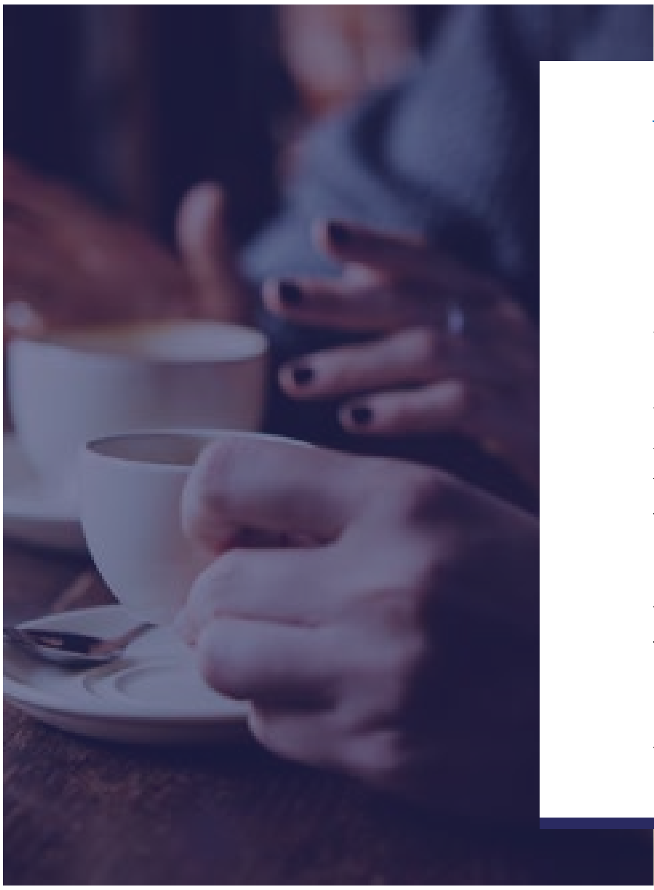
There is also something known as the 'residence nil rate band'. It essentially means that if you leave your main residential property to your children or grandchildren, you can increase your tax-free allowance by £175,000 to £500,000.

For example, if your estate is valued at £2 million and you leave your property to your children, IHT will only be payable on £1.5 million (£2 million less the normal tax-free allowance of £325,000 and the additional allowance of £175,000). The tax liability would therefore be £600,000 (40% of £1.5 million).

In some circumstances, this can be an excellent way of reducing an IHT bill as, for many people, their property is their most valuable asset. It's also important to note that the additional nil rate band reduces by £1 for every £2 by which the value of an estate exceeds £2 million. This means that you shouldn't expect this additional £175,000 allowance to be available if your estate exceeds £2,350,000.

If all or part of the additional £175,000 has not been utilised when someone dies, then the unused portion can be transferred to their spouse or civil partner. For example:

- A person dies with an estate of £400,000, and no IHT is payable at this stage as the entire estate is covered by the main nil rate band (£325,000), plus £75,000 of the residence nil rate band
- The remaining £100,000 of the residence nil rate band can then be used by their spouse and added to their own residence nil rate band of £175,000.

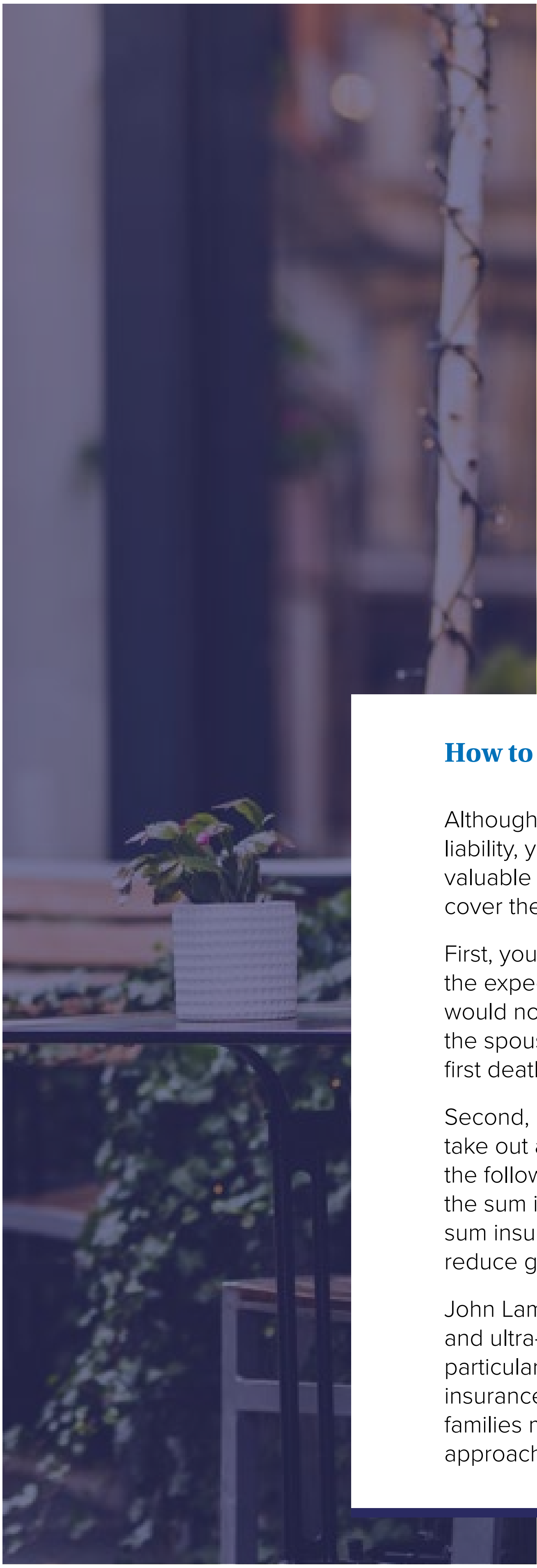


Why it is important to make a will

Too many people fail to make a will, but it really is the only way of making sure that your assets go to your intended beneficiaries when you die.

We've already seen that IHT isn't due on anything you leave to a spouse or civil partner. However, if you die without a will, your spouse will only receive the first £270,000 of your estate, plus 50% of anything above that amount. That is why it is important to use your will to make sure they do not pay more IHT than necessary.

Many people also use a will to give legacies to their favourite charities. Anything that you leave in your will to a charity will be exempt from IHT. Also, if you leave at least 10% of your estate to charity, then the overall IHT rate applied to the rest of your estate will be reduced from 40% to 36%.



Trusts

Trust planning is a complex area, and ideally you should seek legal advice before doing anything related to trusts. A trust is an arrangement whereby you appoint certain individuals, known as trustees, to manage assets on behalf of your beneficiaries after you die.

It is important to seek advice here, as some forms of trust, such as a 'bare trust', don't help in mitigating IHT. A 'discounted gift trust' is one of the more common structures for assisting with IHT issues.

IHT on a trust is payable at 20% when you set it up, and then it's 6% tax at each 10-year anniversary and 6% when the trust is closed, or assets are withdrawn from the trust. Given that the standard rate is 40%. You can see how this might be a way of significantly reducing your estate's IHT liability. The £325,000 tax-free allowance also applies here.

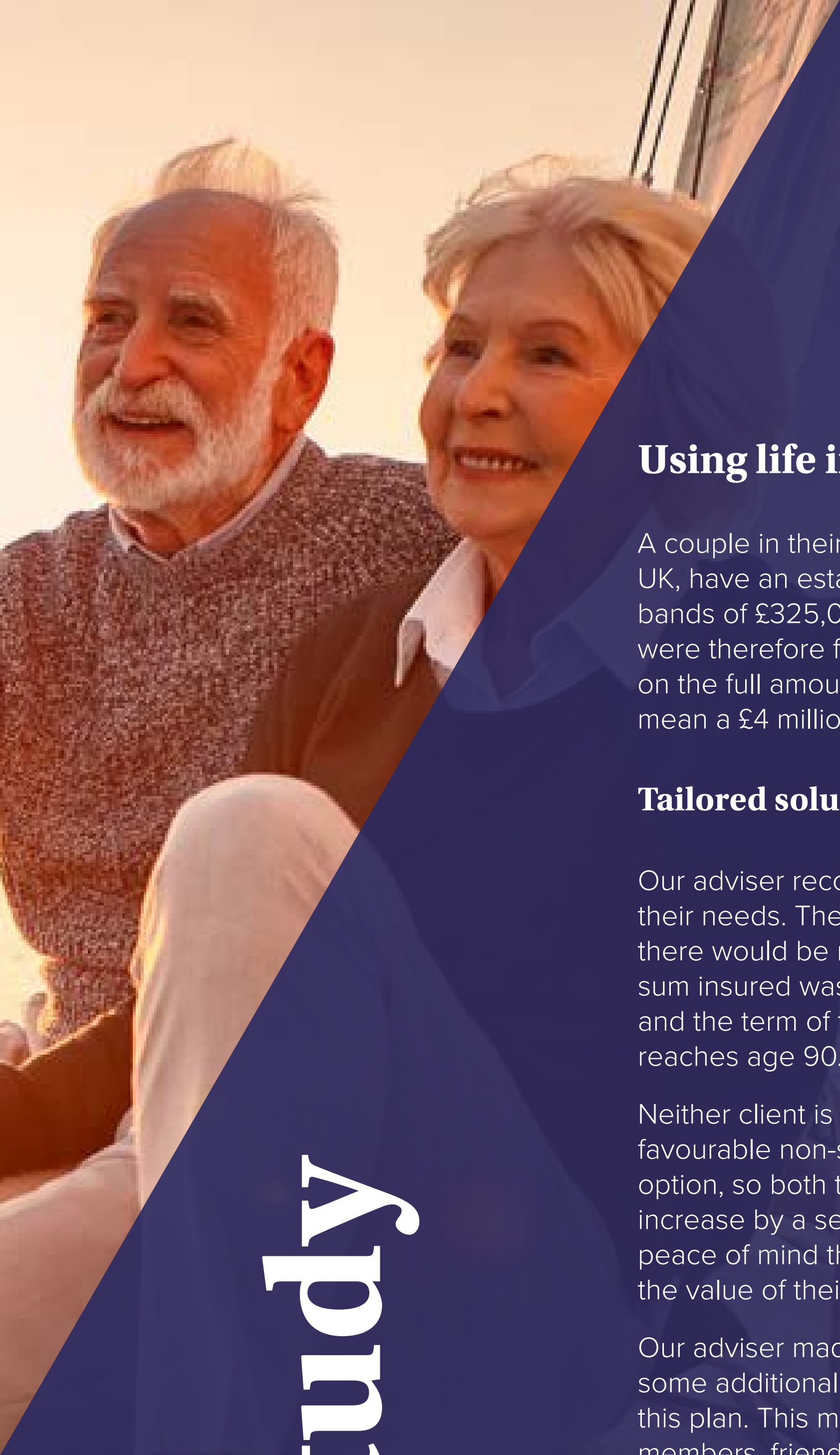
How to mitigate the effects of IHT using life insurance

Although there are a number of ways to reduce your estate's IHT liability, you may still leave behind a significant tax bill. Another valuable strategy you can use is to put in place life insurance to cover the liability.

First, you can take out a policy where the sum insured matches the expected liability on death. For a married couple, this policy would normally be written on a joint life, second death basis, as the spouse would expect to inherit the estate free of IHT on the first death.

Second, if you make any gifts during your lifetime, you can then take out a policy that will pay out if you were then to die during the following seven years. It's also possible to find policies where the sum insured will reduce in line with the taper relief, so the sum insured will be highest in the first three years and will then reduce gradually in years four to seven.

John Lamb Hill Oldridge specialises in advising high-net-worth and ultra-high-net-worth individuals on IHT planning, placing particular emphasis on how putting in place appropriate life insurance can help in this respect. We have helped many families mitigate their liabilities using a variety of tried and tested approaches.



Case study

Using life insurance to mitigate IHT

A couple in their 60s, who are British nationals and resident in the UK, have an estate valued at £10 million. Their individual nil rate bands of £325,000 each could not be used in this case, and they were therefore facing the prospect of IHT of 40% being charged on the full amount once the second client died, which would mean a £4 million IHT bill for their nearest and dearest at that time.

Tailored solution

Our adviser recommended a joint life insurance policy to address their needs. The policy was set up on a second death basis, as there would be no IHT liability at the time of the first death. The sum insured was £4 million to cover the full potential IHT liability, and the term of the plan ends when the older of the two clients reaches age 90.

Neither client is a smoker and the policy was set up on more favourable non-smoker rates. The clients chose the indexation option, so both the sum insured and the premiums payable will increase by a set percentage each year. This should give them peace of mind that they will still be adequately covered, should the value of their estate increase in the coming years.

Our adviser made the clients aware that they should carry out some additional IHT planning before the end of the term of this plan. This might, for example, involve making gifts to family members, friends, charities or anyone else they wish to benefit.

One of the reasons for advising them of the need for additional IHT planning was that it was not possible to arrange a whole-of-life policy for £4 million, as the cost of this was in excess of the clients' budget. However, while taking out a fixed-term plan might not be regarded as a 'permanent' solution, it is much better that the clients have some form of insurance in place. Taking out a term plan then gives them time to make alternative arrangements or re-organise their affairs.

Advising on suitable life insurance to assist with IHT planning is one of the principal services we offer here at John Lamb Hill Oldridge. As part of our commitment to ongoing service, we look forward to continuing to work closely with these clients in the coming years, as their needs and circumstances evolve.

Next steps

Whether your clients are looking to manage their IHT liabilities for the first time or review their existing plans, we will be happy to explain what we offer and provide as much detail on our company and services as you need.

Meetings can be held at our office in London, at a location to suit you or online. If you would like further information or to arrange an initial conversation, please email mail@jlho.co.uk or call 020 7633 2222.

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