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Inheritance Tax Guide

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Solicitors For Older People Scotland

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GUIDE TO INHERITANCE TAX

Many people are under the mistaken apprehension that Inheritance Tax is a tax on the wealthy. This statement might have been accurate when it was first introduced in the 1970s but due to recent surge of property prices it can no longer be relied upon.

If we have thought about Inheritance Tax, many of us have concerns that any property we leave on death will not go to our family as we would wish but instead will find itself in the tax man's pocket.

Unfortunately paying our taxes is a fact of life. Inheritance Tax, however, is slightly different as with a bit of forward planning many people will certainly manage to reduce, and in some cases, completely avoid, their liability to Inheritance Tax. Exemptions and reliefs to the tax can be constructively used to minimise liability.

To aid people with their concerns we have prepared a guide to Inheritance Tax to give the reader a better understanding of when and how the tax is paid. The guide will also highlight ways in which your liability to Inheritance Tax can be reduced if not avoided.

WHAT IS INHERITANCE TAX? (IHT)

IHT may be payable on an individual's estate on death or on certain gifts made during the lifetime. The tax legislation states that IHT is payable on chargeable transfers of value made by persons during their lifetime or on death. For IHT purposes when a person dies they are deemed to have made a transfer of all their property. Although some people may become liable for Inheritance Tax during their lifetime as they have made lifetime chargeable transfers (this will be explained later in the guide) the majority of people will only become liable to pay IHT on their death.

WHO PAYS INHERITANCE TAX?

IHT is payable by people who are domiciled in the UK. If you have the UK as your permanent home all of your assets, with a few exceptions, will be subject to IHT. Please note that even if you are not domiciled in the UK, any assets held in the UK will be subject to IHT.

WHAT RATE OF INHERITANCE TAX IS PAYABLE?

The rate of tax chargeable on lifetime transfers is 20%. The rate of tax on death is 40%.

IHT will only become payable if the chargeable transfer exceeds the Nil Rate Band (NRB). The NRB tends to change at the start of any new tax year. The current NRB for tax year ending April 14 stands at £325,000.

EXAMPLE

John, a widower, dies in June 2013. He leaves a net estate of £412,000. The whole estate has been left to his 2 children. The IHT is calculated as follows:-

| | |
|------------------------------|----------------|
| Estate | £412,000 |
| Deduct NRB | £325,000 |
| Chargeable estate | £87,000 |
| Tax @ 40% IHT payable | £34,800 |

There are also new rules brought in relating to unused NRB or spouses and civil partners. It is now possible for spouses and civil partners to transfer any part of the NRB which is unused when the first spouse/civil partner dies to the individual's surviving spouse/civil partner. Therefore on the death of the surviving spouse or civil partner their NRB will be increased by the proportion of the unused NRB of their partner. This rule is better explained by way of an example.

EXAMPLE

John and Mary have been married for 45 years. On Mary's death her chargeable estate amounts to £150,000. At the time of her death the NRB stands at £300,000. Therefore 50% of the NRB has been unused. John dies 4 years later. His chargeable estate amounts to £475,000. On his death the NRB stands at £325,000. As he can transfer the proportion of unused NRB on Mary's death, the NRB for his estate will be increased by 50% to £487,500. Accordingly all of his chargeable estate will be below the NRB and no IHT will be chargeable.

Rules will apply to all survivors of a marriage/civil partnership who die on or after 9th October 2007, irrespective when their partner died. Currently it is possible for a surviving partner of a marriage or civil partnership to have an NRB of up to £650,000. This rule is an obvious tool in the search for avoidance of IHT

WHAT IS A TRANSFER OF VALUE?

We have already said that all transfers of value are chargeable to IHT. Any gratuitous transaction or gift which reduces the value of an Estate of an individual is a transfer of value. Every transfer of value is chargeable to IHT unless it is specifically exempt. The value of the transfer is the reduction in value of the Estate. This is mostly, but not always, the value of the asset being transferred. The transfer of value can be made during lifetime or death. Transfer of Value can be categorised as a Lifetime Chargeable Transfers, Potentially Exempt Transfers or Exempt Transfers.

LIFETIME CHARGEABLE TRANSFERS

Tax is payable on the Lifetime Chargeable Transfers at the time of transfer. The tax is charged at 20%. A transfer becomes chargeable if it is not specifically exempt or a potentially exempt transfer. Generally only a gift into a discretionary trust will be a lifetime chargeable transfer.

A discretionary trust is a Trust where the Trustees have a wide discretion as to how they can distribute the income of the trust to the beneficiaries. The rule on how IHT are calculated on gifts to a discretionary trust is very complex but the main rules are as follows.

On each 10th anniversary of the creation of a discretionary trust a charge will arise on the property of the trust which exceeds the NRB.

There will be an IHT exit charge for any capital which is distributed to the beneficiaries. The rules on how the tax is calculated are extremely difficult and beyond the realms of this guide. To simplify we can say that the rate will currently not exceed 6%.

If you require further information or clarification on discretionary trusts you should seek specialist advice. Our Executry Department can help with this advice and their contact details can be found at the end of this guide.

EXEMPT TRANSFERS

If a transfer is specifically exempt then it is never liable to IHT. With a bit of planning you can use the exemption categories to avoid or reduce your IHT bill. The exempt categories are as follows:-

a. Transfers between Spouses and Civil Partners

Any estate passing to your spouse/civil partner will be exempt from IHT (unless your spouse has a foreign domicile where restrictions apply). This is obviously a very useful tool for tax planning purposes. It should be used in conjunction with the rule on transfer of unused NRBs between spouses and civil partners. Here are 2 examples demonstrating how this rule can be used to your advantage.

EXAMPLE 1

Mary dies in June 2013 leaving her husband John and 2 grown up children. Mary leaves a chargeable estate of £475,000. She leaves a Will distributing £375,000 to John and £50,000 to each of her children.

| | |
|-------------------------|-----------------|
| Chargeable estate | £475,000 |
| Deduct Spouse exemption | £375,000 |
| Total | £100,000 |
| Deduct NRB | £325,000 |
| IHT chargeable | £0 |

Also the proportion of unused NRB can be transferred to John's estate on his death. (69.24% of NRB).

EXAMPLE 2

Same scenario as above but this time, as John is independently wealthy she leaves John £100,000 and divides the remainder of the estate equally between her 2 children.

| | |
|------------------------------|-----------------|
| Chargeable estate | £475,000 |
| Deduct Spouse Exemption | £100,000 |
| Total | £375,000 |
| Deduct NRB | £325,000 |
| | £50,000 |
| Tax @ 40% IHT payable | £20,000 |

Furthermore as all NRB has been used up you cannot utilise the rule on transfers between spouses of proportion of unused NRBs to reduce IHT bill on John's death.

b. Annual Exemption

You are allowed to make lifetime gifts not exceeding £3000 in any tax year (i.e. total gifts made). You are allowed to carry this exemption forward for one year. You can bring forward all or any part of exemption used from the preceding tax year.

EXAMPLE

| | | |
|------------------------------------|---------|--------------|
| Chargeable gift (Made in May 2008) | £10,000 | |
| Less 2007/2008 Exemption | £3000 | |
| Unused 2006/2007 Exemption | £3000 | (£6000) |
| Chargeable Transfer | | £4000 |

c. Small Gift Exemptions

Outright gifts (gifts with no strings attached) of up to £250 to any one person are exempt. There is no limit to the number of persons whom these gifts can be given as long as each person doesn't receive more than £250. This exemption doesn't apply to transfers on death or transfer to or from a trust.

This exemption cannot be used in conjunction with the annual exemption. For example John gives his grandchild a gift of £500. He can't deduct £250 from his annual exemption and then say the remaining £250 is exempt under the small gift exemption. The whole £500 will have to be deducted from John's annual exemption.

d. Lifetime Gifts in Consideration of Marriage or Entering a Civil Partnership.

These are exempt to the following extent:-

By each parent to his or her child up to £5,000

By a grandparent up to £2,500

By any other person up to £1,000

Please note that this exemption applies to each parent. Therefore each parent may gift their child £5,000 on the occasion of their child's marriage i.e. the child receives £10,000 in total.

e. Charitable Bequests

All gifts (either made on death or during lifetime) made to charities, political parties and bequests to certain bodies concerned with the preservation of the National Heritage or of a public nature (eg Universities, The National Trust etc etc) are exempt.

To qualify for this exemption the charity must be a registered charity.

f. Normal Expenditure

Lifetime gifts which represent normal expenditure out of income are exempt. To qualify the gift must be made regularly and out of income, not capital. Furthermore you must demonstrate that the donor's standard of living was not adversely affected.

The type of things that will be included under this exemption will be payments to a life insurance policy, gifts at birthdays, Christmas and anniversaries.

g. Maintenance Gifts

Lifetime gifts for the maintenance of children who are under 18 or in full time education, for dependent relatives or for spouse, civil partner, ex spouse/civil partner are exempt.

h. Potential Exempt Transfers (PETs)

If a gift is not a lifetime chargeable transfer or exempt then it will be a PET. No IHT is immediately due on the date the gift is made. IHT will only become due if the donor doesn't survive for 7 years from the date of the gift. If the donor does survive 7 years the gift will become exempt from IHT. Please note it is the recipient not the donor who becomes liable to pay the IHT.

Obviously if the legislators had omitted this rule it would be very easy for everybody to avoid paying IHT completely as we would ensure we gifted all our worldly possessions shortly before death. Gifting your estate, however, can still be a useful tool to avoid IHT liability.

The amount of tax you will have to pay on such gifts depends on the length of time which has elapsed from the date of gift to the date of death. The longer the donor has survived the less tax will be due. The tax charged will be at the rate applicable at the date of death, however, the rate will be subject to taper relief which reduces the rate according to the years of survival.

| Years between gift and death | % of charge at death rate |
|------------------------------|---------------------------|
| 0-3 | 100 |
| 3-4 | 80 |
| 4-5 | 60 |
| 5-6 | 40 |
| 6-7 | 20 |

EXAMPLE

Fraser dies in June 2008 having gifted cash of £355,000 to his brother Campbell in May 2004. (Fraser has no available exemptions)

| | |
|---------------------------------|----------|
| PET | £355,000 |
| £325,000 at NIL | NIL |
| £30,000 @ 40% | £12,000 |
| Death occurred Within 4-5 years | |
| Of making gift (60%) | |
| Tax payable by Campbell | £7,200 |
| £12,000 x 60% | |

WHAT ARE THE RELIEFS AVAILABLE?

There are certain reliefs available which will reduce your IHT bill

I. Taper relief on PETs

This has already been discussed in the paragraph relating to PETs.

II. Agricultural Property Relief.

For a working farm the relief is 100% and for let agricultural property the relief is 50%. It is given on the value of the agricultural property which means land and buildings occupied or agricultural purposes. It doesn't include livestock, dead stock or farm implements but these may qualify for business property relief (see below).

III. Business Property Relief

There is a relief of 100% on business property as long as the property has been owned for 2 years.

Business Property Relief extends to unquoted shares, forestry and agricultural land and shares listed on the AIM (Alternative Investment Market). For the person trying to avoid IHT these assets may be worth investing in.

IV. Woodlands Relief

There is a specific 100% relief for transfers of woodland on death. This relief relates to the value of the timber (the trees and the under wood) but not to the underlying land. However the land could benefit from agricultural or business property relief.

V. Quick Succession Relief

If a person inherits an asset on the death of another and then dies within a short space of time that asset will suffer IHT again on the second death. Quick Succession Relief mitigates this double taxation by giving a reduction on IHT payable on the asset on the second death.

The amount of relief of credit is 100% if second death occurs within 1 year of the first death with a sliding scale relief up to maximum of 5 years.

| | |
|----------------|------|
| 1 year or less | 100% |
| 1-2 years | 80% |
| 2-3 years | 60% |
| 3-4 years | 40% |
| 4-5 years | 20% |

EXAMPLE

Fraser dies leaving his whole estate of £320,000 to Campbell on which IHT is paid of £8000. Campbell dies 2 and half years later.

On Fraser's death Campbell's estate increased by £312,000 (£320,000 -£8000)

Therefore amount of tax eligible for relief is $(312,000 \times £8000) / 320,000 = £7,800$

Quick Succession Relief 60% (2-3 years) x £7,800 = £4680

IHT payable on Campbell's estate will be reduced by £4680.

USING EXEMPTIONS AND RELIEFS

Although IHT is a fairly complex taxation, by utilising the exemptions and reliefs already detailed avoidance of the tax is fairly straightforward. You should look at your own circumstances and ensure that you have utilised all the exemptions and reliefs available to you to successfully minimize your IHT bill.

For example if you are married or in a civil partnership are you making use of the spouse exemption and the transfer of the nil rate bands effectively?

Have you thought about gifting some of your assets? Although you must survive for 7 years to avoid liability altogether it can still be an efficient way of reducing your tax bill.

With a small amount of effort and some specialist advice you can make an enormous difference to your liability.

Many people do not make any planning steps and unfortunately end up paying fairly large amounts of money to the tax man which could have easily been avoided. It is a very difficult thing to plan for your death but if you want your estate to fall to your close family rather than the tax man it is a necessity.

GIFTS WITH RESERVATION

Although gifting property can be a useful tool in reducing your IHT liability you must ensure that any it is an outright one.

An outright gift is where the gift is given to the recipient with no strings attached and they receive the full benefit of the asset gifted.

A good example of a gift with reservation is where a mother gifts a house to her son but continues to live in the house without paying market rent until she dies. In this scenario the transfer of the house will not count as a gift for IHT purposes. In effect the house will still form part of the mother's estate on death.

EXAMPLE

"A" gifts flat to "B" but continues to live there without paying any rent until her death 4 years later. At date of the gift the flat was valued at £80,000. On date of "A"'s death as the gift was with reservation the flat will

be deemed to be part of "A"'s estate. Furthermore the value of the flat has increased to £120,000 on date of death and it is the increased value which will be used for IHT purposes.

If, however, "A" had made an outright gift of the flat it would not have formed part of her estate at death. The gift would have been deemed a PET. Although if "A"'s estate was large enough there may be IHT chargeable on the gift as it was made 7 years before her death, the amount payable would be less than the last scenario. Not only would the lower value of £80,000 be chargeable, but it would also attract more relief as it has been over the 4 years since the gift was made.

There may also be income tax implications of a gift with reservation. If you continue to receive benefits from certain types of property which you previously owned income tax will be payable on this benefit. The tax is calculated on the value of the asset or its rental value.

CAPITAL GAINS TAX (CGT)

Trying to reduce your IHT bill by gifting your assets must always be looked at in conjunction with CGT. The benefits of making lifetime gifts may have been eroded by CGT. CGT can arise on disposal of an asset. This can include gifts. For CGT purposes if you gift an asset it is treated as if you sold the asset at full market value.

There is an annual exemption to CGT which at the moment stands at £10,900. If your total gain on disposals exceed this amount in any one tax year you may find yourself liable to CGT. The additional gain is treated as additional income.

There is the possibility of using "holdover relief" which defers payment of any CGT until recipient subsequently disposes of the asset. Holdover Relief has recently been amended to that there are any certain types of assets that will qualify for its use.

Although the details of the CGT are beyond the realms of this guide, you should always consider any CGT implications when IHT avoidance measures are put into place.

If you require any further information on CGT you should seek professional advice.

TRUSTS

Setting up a Trust can be an effective way of reducing or avoiding IHT liability either during your lifetime or on your death.

HOW DOES A TRUST WORK?

You will gift assets to the Trust. The appointed Trustees are legal owners of the assets and manage and control the assets on behalf of the beneficiaries. This allows you to make a gift to a beneficiary without them gaining control immediately. It allows perhaps grandparents to gift assets to their grandchildren without them receiving it until a certain age or until a certain event eg providing funds for private education. You can also set up a Trust in a Will in the event of any of the beneficiaries are still children at the date of your death.

Before changes to the law made by The Finance Act 2006 Accumulation and Maintenance Trusts were termed “favoured trusts” and no IHT was chargeable on them. It was common for grandparent to set up such a Trust for the benefit of their grandchildren. After The Finance Act these Trusts are no longer “favoured” and are taxed as discretionary trusts.

Taxation of Trusts will depend on whether or not they are deemed to be a Discretionary Trust. Gifts to a Discretionary Trust are deemed Lifetime Chargeable Transfers and are subject to an immediate charge to IHT. There is also a 10 year anniversary charge on the assets of the Trust. The complex rules on taxation of Discretionary Trusts were discussed earlier in this article. If not a Discretionary Trust gifts to the trust may be considered PETS.

The law on and taxation of trusts is a very complicated and difficult area. If you are considering setting up a trust or just wish some further information please contact our team who will be able to give you specialist advice on this area. The contact details can be found at the end of this guide.

NRB DISCRETIONARY TRUSTS

In the past setting up an NRB Discretionary Trust was an extremely effective way for a spouses/civil partners to avoid IHT liability.

Due to the recent changes to the legislation on the transfer of NRBs between spouses these trusts are often not tax-efficient.

WHAT IS A NRB DISCRETIONARY TRUST?

You direct an amount equal to the NRB into Trust to your children or another person or persons. The idea is to utilise both the husband and wife’s NRBs. The Trust operates on the death of the first spouse.

Under the old rules if the first spouse left everything to the surviving spouse this would result in no IHT being payable on the first death. It may, however, just simply postpone payment of IHT until the occasion of the second death.

An alternative would be to leave the NRB outright to your children in your Will. This may cause problems if the surviving spouse is not adequately provided for.

If you created a Discretionary Trust under a Will the surviving spouse is still capable of benefiting from the Trust but Trust assets do not form part of their estate.

Before the legislation change on transfers of NRBs between spouses and civil partners these trusts were very popular and were included in a great number of Wills. Due to the legislation change they will quite often be counterproductive.

EXAMPLE

The NRB is £300,000. The spouse has a NRB Trust. When the second spouse dies 6 years later the NRB is £400,000. The total tax free allowance is £700,000.

If the first spouse did not have a NRB Trust and left everything to the surviving spouse the tax free allowance would be £800,000.

If you have a NRB Discretionary Trust inserted in your will we would strongly advise you to review this immediately. It may be the case you should be amending your Will.

Please note that there are still some circumstances where it will still be beneficial to have a NRB Trust.

For example if you believe the assets passing into the trust may gain in value substantially.

In addition a NRB Trust often allows the Trustees to make interest free loans available to the surviving spouse. On the death of the surviving spouse these loans will be a debt on their estate thus reducing their assets.

Furthermore if it is thought likely that long term nursing care may be required the Trust is still an effective way of lowering assets which will be accountable for assessing nursing home costs.

To find the right option for you and your family please contact our team for advice.

PENSIONS

Pension death benefits are usually paid to someone else. If this is the case they do not form part of the deceased's estate and therefore will be exempt from IHT.

Usually payments of a pension or other benefit cease on death. Occasionally the person may have guaranteed payments for a fixed price and the person dies before the fixed period. If payments continue to be paid to the estate then the value of the right to receive remaining payments should not be included for IHT purposes. Payment made to deceased widow, widower or surviving civil partner need not be included.

PAYMENT OF THE IHT BILL

If it is inevitable, even after some efficient tax planning, that IHT will be payable, you might be concerned how the money will be raised to settle your liability. If a large part of your estate comprises of land or buildings you may not want the property to be sold to raise money for the IHT bill as this may lead to hardship for some of your family members.

IHT on a deceased's estate must be paid within 6 months from date of death. If payment is not received timeously interest will accrue. You can arrange to pay IHT by instalments. Instalments can only be made on tax relating to land and buildings and not on the whole tax bill.

You may therefore wish to set up a Life Assurance policy which will pay out a tax free cash sum to settle the IHT liability.

It is imperative that this life policy is written in Trust. It will therefore not form part of your or your surviving spouse's estate. The payment realised from the policy will be paid tax free.

If you are married or have a civil partner you can set up a joint life policy where the proceeds are paid on the second death.

Although it should be noted that any payments to such a policy will be transfers of value for IHT purposes, they more often than not will fall within the normal expenditure exemption. Failing that payment can be set against your annual exemption.

Again if you would wish some further information on Life Assurance policies or any issue relating to the payment of IHT please do not hesitate to contact our team.

MAKING A WILL

The importance of making a Will cannot be stressed heavily enough. Asides from avoiding IHT it ensures your assets go to whom you would like. If you die intestate (no Will) in Scotland your estate will be divided according to the law. On investigating the laws many people are extremely surprised as to who inherits on an intestate estate. For example your estate will not automatically pass to your unmarried partner. Please read our Guide to "Why You Should Make a Will" found on our website under the Will Category of Our Services for full information.

Drawing up a Will also ensures that as little as possible will go to the tax man. You can draw up your will taking advantage of all the exemptions and reliefs available to you to avoid paying IHT.

It is also imperative to keep updating your Will as your life changes.

WHAT YOU SHOULD DO NOW

Although IHT is no longer a tax on the wealthy, liability is not a foregone conclusion. As the guide has shown there are a number of methods to reduce your IHT liability.

Look at your financial circumstances and assess your potential IHT liability.

Is there any scope for making any lifetime gifts? The underlying philosophy for IHT is that gift by an individual will be exempt provided the donor survives for 7 years. Remember that the gifts must be outright gifts with no reservation of benefits.

Ensure that you have taken advantage of the annual or other IHT exemptions and reliefs.

Look into the benefits of setting up a Trust. Existing trusts should be kept under constant review.

Consider whether your Life Assurance and Pension arrangements do not aggravate any potential IHT.

Wills should be made. Any existing Wills should be kept under constant review.

We hope this guide has been of assistance to you and has given you a basic understanding of IHT. The guide sets out the basic rules and principles of this very difficult area. It does not provide a full explanation of how IHT is calculated, nor does it try and substitute the need to obtain specialist advice. If after reading this guide you feel you should be taking further action we would urge you to obtain expert advice.

CONTACT US

If you have any questions or would wish some expert advice on this complex area please contact us where a member of our specialist team will be delighted to help you.