Our Guide to

Inheritance Tax & Estate Planning

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Accountants, Business & Financial Advisers

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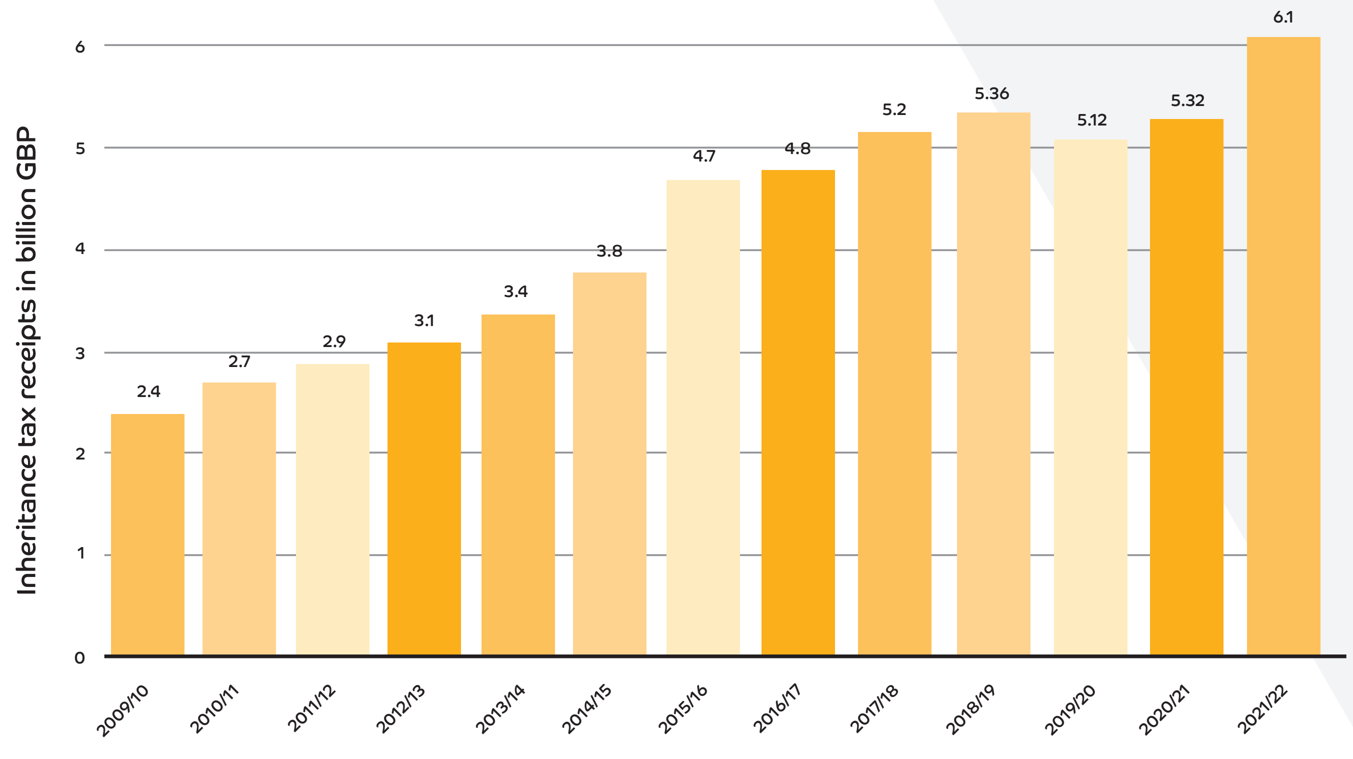
Contents

Why is inheritance tax (IHT) an issue?

Many people question why they are effectively being taxed twice on their assets. Once while earning them throughout their life, and then a second time when they die.

However, if you thought inheritance tax was now simply for extremely wealthy people to worry about, think again. Rising property prices have meant more estates than ever are likely to face an inheritance tax bill. HMRC collected £6.1 billion from thousands of bereaved families in 2021/22 (www.gov.uk/government/statistics/inheritance-tax-statistics). In fact, the amount of inheritance tax collected currently is expected to reach £6.9 billion by 2023-24, an increase of £1.5 billion in just five years (HM Treasury Budget, October 2018).

Inheritance tax receipts in the United Kingdom from 2009/10 to 2021/22 (in billion GBP)



Source: HMRC

Many people question why they are effectively being taxed twice on their assets.

Understanding when inheritance tax becomes payable

If your estate has an inheritance tax liability, the people you want to leave your assets to, i.e. your beneficiaries, are the people who ultimately will have to pay the IHT bill. This may not be the kind of legacy most people think of leaving behind.

Inheritance tax is paid on the value of the assets that a person leaves behind when they die. It can also apply to some gifts and transfers that are made before someone dies.

If you are married, or have a civil partner, you are able to leave your entire estate to your spouse or partner free of inheritance tax. But if you want to leave some or all of your estate to family and friends, then it may be liable for IHT. And you also need to consider, as part of your estate planning, what happens when the second spouse/partner dies.

This is something that many families can overlook. The earlier you put plans in place, the more options you may have.

Examples of assets included in your estate:

- Value of main home/residence
- Other property (second home, holiday home, business property/land etc.)
- Cars, boats or caravans
- Household contents/personal effects
- Antiques, jewellery, art and/or collectable
- Bank and/or building society accounts (including cash ISA's)
- Investments (including stocks and shares, ISA's)
- Life insurance policies (not in trust)
- Death in Service (not in trust)
- Other assets e.g. funds drawn out of pension(s)

What are the current allowances?

Currently everyone has a tax-free inheritance tax allowance of £325,000 – known as the **Nil-Rate Band.** The allowance has remained the same since 2010-11 and continues to be frozen until 2025/26. The standard inheritance tax rate is 40% of your estate over the £325,000 threshold.

Married couples and civil partners are allowed to pass their assets to each other tax-free. The surviving partner is allowed to use both tax-free allowances, providing the first spouse did not use any of their own inheritance tax allowance by giving away assets in their will.

In an attempt to alleviate the burden of IHT on increasing property prices, the Government also introduced another allowance called the **Residence Nil Rate Band** (RNRB) in addition to the mentioned Nil Rate Band. This is a complex allowance with various exceptions and caveats attached.

In the current tax year, the RNRB is £175,000 each. This means a married couple or civil partners could pass £1m to their direct descendants. The rate is maintained up to and including 2025/26.

To benefit from the RNRB allowance, you must meet a number of criteria which are as follows:

- ✓ At the time of death you must own a family home. This is defined as a place of main residence or a home that was your past main residence which you still own. Special protection is provided for those who sell their property or downsize to go into care, so long as the sale of the property occurred on or after the 8th July 2015.
- ✓ Your family home must be left to 'direct descendants', usually your children, but in some circumstances, your grandchildren.
- ✓ The value of your estate must be greater than £325,000 (single) or £650,000 for married couples in order to claim the RNRB allowance, otherwise you are covered by the usual tax free amount.
- ✓ Generally, for estates worth more than £2m, the RNRB will taper away at a 2:1 basis. This means for a single person in 2020/2021, for example, the RNRB will be lost when their estate exceeds £2.35m, and likewise for married couples when they exceed £2.7m.
- ✓ When working out how much your total estate is worth, you don't take off any exemptions such as spouse exemption or reliefs such as Agricultural and Business Property Relief.

Are you aware of and using all of your available allowances?

An example of how the current IHT allowances work

Husband dies leaving a wife and their adult son. The family home was valued at £400,000 at that time and other assets, such as investments and cash, totalled £1,000,000. Everything was held jointly between the husband and wife.

The spousal exemption applies meaning that ownership of the family home and other assets passes to his wife under the spousal exemption, IHT free.

Subsequently the wife dies and leaves her estate to her son. The house has increased in value to £600,000 and the other assets are now worth £800,000, giving a total estate of £1.4 million.

The standard nil rate band of £325,000 can be used for both the husband and wife and the RNRB is also available to use against both estates as his was not used before her death.

Therefore, the wife's estate, on her death, can benefit from a total of £1 million in nil rate bands; two standard nil rate bands of £325,000 and two RNRBs of £175,000.

After allowing for the available nil rate bands, the residual value of the estate is £400,000 and IHT of 40% means a tax liability of £160,000 on the amount being inherited by the son.

How to mitigate against IHT - what are the first things you need to consider?

Making a will

Thinking about how your assets will be distributed after your death is not always a comfortable thought, however, it is one of the most important and valuable things you can do. At the very least you should make a will so you decide who benefits from your assets. If you don't clarify your wishes in a will, the law will take over and distribute your estate according to a formula set out in the rules of intestacy. The results are not always what you would expect and can also potentially create unnecessary tax consequences.

Additionally, a will can also be used in the initial planning to help reduce your IHT liability. However, many people often procrastinate when it comes to writing a will. We would therefore encourage everyone to make a will as soon as possible. According to research by Canada Life 3 in 5 adults in the UK don't currently have a will. This should be a concern for anyone who has accumulated a reasonable level of financial assets including property wealth. Hence, making your will now can be instrumental for preserving your assets and reducing your IHT liability, especially when taking into account the new RNRB.

Notably, any wills drafted before the RNRB was introduced in 2017 should be professionally reviewed, to ensure you are making the most of the RNRB tax allowance.

A deed of variation, sometimes called a deed of family arrangement, allows beneficiaries to make changes to their entitlement from a will after the person has died. You might want to do this if you don't need all your inheritance and would like it to go to someone else. This can also help minimise inheritance tax in the right circumstances.

Gifts

Potentially Exempt Transfers (PET's)

To gift outright means giving your assets away absolutely. Once gifted these cannot be taken back as they will become a Gift with Reservation. Gifts made during your lifetime may be exempt from inheritance tax, however, you must live for 7 years after making the gift for it to be completely outside of your estate. If you do not, the value of your gift will count towards your nil-rate band allowance of £325,000. If it does fail within 7 years of your death, and the gift exceeds the available nil rate band, then there is a "taper relief system" as follows:

Years between gifting and death	Tax payable	Tax payable (effective rate of tax)
Less than 3	100%	40%
3 - 4	80%	32%
4 - 5	60%	24%
5 - 6	40%	16%
6 - 7	20%	8%
7 +	0%	0%

The Annual exemption (gifts)

The annual exemption rate is set at £3,000. Simply put, this exemption could save you £1,200 in inheritance tax per year and enables you to gift up to £3,000 to a person or trust of your choosing. Once made, the gift is treated as exempt, immediately becoming excluded from the inheritance tax estate.

Married couples are able to utilise two allowances, giving them a total of £6,000 per year to use. Additionally, for people who have not used the annual exemption in the past, an added bonus is that you can carry this one year forward too. So that means a total initial gift of £12,000 for a married couple and £3,000 for each year after should you wish (or can afford) to do so.

Despite these amounts seeming small relative to someone with a significant estate, the annual exemption's compound effect over a period of time can generate significant IHT savings.

The £250 'Small Gifts' Exemption

The £250 'small gifts' exemption enables you to give £250 to any number of people of your choosing, and will immediately be exempt from IHT. However, the drawbacks of this exemption means you are unable to use it together with other exemptions and can't be included in a larger gift. For example, you cannot give £250 as a small gift to someone along with the £3,000 annual exemption. It is, however, despite being relatively small, worthy of consideration.

Chargeable lifetime transfers (CLTs)

Put simply any lifetime transfer that does not qualify as a potentially exempt transfer (PET) is will be immediately chargeable to inheritance tax.

A CLT will arise where you make a gift into a relevant property trust or transfer to a company.

A CLT will be subject to an immediate charge to IHT at 20% where the value of the CLT, when added to any other CLTs made by you (the settlor) in the preceding seven years, exceeds the IHT nil rate band (that is the main nil rate band not including any transferable or residential nil rate band).

The liability to IHT on the CLT rests with the settlor, although the settlor and trustees can agree between them as to who pays. The amount of the transfer must be grossed up if the settlor pays the tax.

If the donor survives for seven years from the date of gift there will be no further IHT payable but there is no refund of any IHT paid at outset.

Gifts out of Normal Expenditure

This exemption allows you to make gifts to an individual or trust, with no upper limits, providing that that the following conditions are met:

- Each gift is comprised of a regular, natural income
- The gifts must have some form of regularity.
- The making of the gift cannot allow your standard of living to fall below where it would have been prior to when the gifts started to be made.

Albeit difficult to evidence and/or demonstrate, this exemption, in the right circumstances, has great potential to significantly reduce your IHT liabilities.

Domicile Considerations

When it comes to inheritance tax planning your domicile is of vital importance. Your domicile origin is generally based on the domicile of your father, not the country in which you were born.

Deemed domicile

Before 6 April 2017 you were UK domiciled if you were resident in the UK for 17 of the 20 years of assessment ending with the year in which the relevant time fell.

From 6 April 2017 you're UK domiciled if you're resident in the UK for 15 of the 20 years.

You can still be treated as UK domiciled even if you're not resident in the UK at the relevant time.

If you left the UK before 6 April 2017 and don't return the new rules don't apply.

If you were born in the UK:

If you move abroad but were born in the UK (with a UK domicile of origin), and have been a UK tax resident for fifteen years prior, you continue to be deemed as UK domiciled for income and capital gains tax until you have been a permanent resident outside the UK for six consecutive tax years.

If you are deemed to be domiciled in the UK, you will pay inheritance tax on worldwide assets.

Formerly domiciled resident

From 6 April 2017 a new category of deemed domicile was introduced.

Here you're classed as a formerly domiciled resident in the following circumstances:

- You were born in the UK with a UK domicile of origin
- You have acquired another non-UK domicile of choice
- You are resident in the UK and were resident in at least 1 of the 2 previous tax years

If you are a formerly domiciled resident, property you settled on trust when you weren't domiciled in the UK aren't excluded for the purposes of IHT. Please note this doesn't however apply if you're only deemed domiciled under the new rules.

If you are returning to the UK to take up permanent residency, having previously acquired a domicile of choice elsewhere, then you will be treated as UK domiciled for tax purposes as soon as you become a UK resident.

Non UK domicile

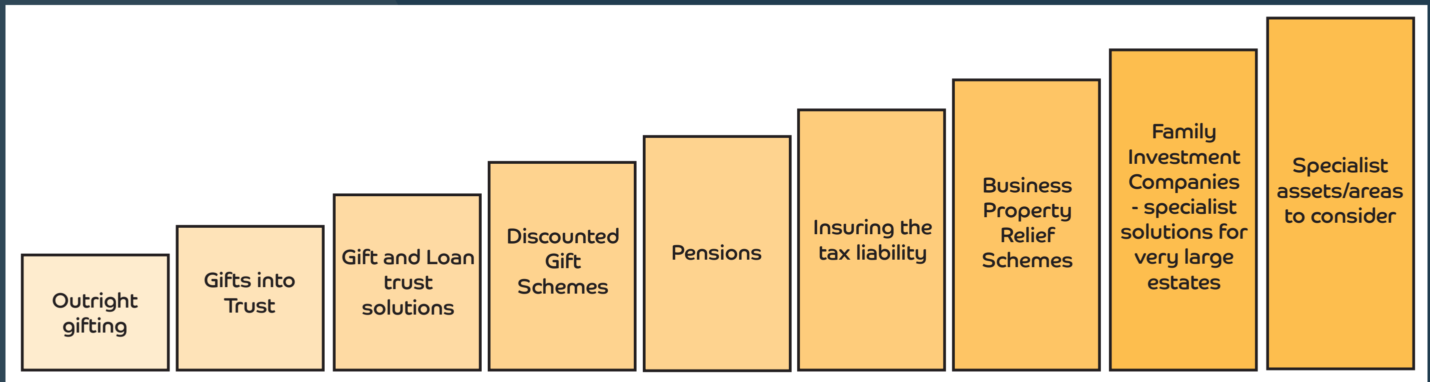
If you've a non-UK domicile of origin you aren't affected by the changes for formerly domiciled residents. You are subject to the deemed domicile rules and the UK residential property rules.

What other steps can I take?

For the majority of people there are a various approaches that can be taken to mitigate a future IHT liability.

Of course, you could choose to ignore it. If there is tax for your family to pay later on so be it. On the other hand you could choose to spend enough money during your lifetime so that little or nothing is left in your estate. However this approach may be more difficult said than done!

If either of these approaches don't suit you then there are other steps to consider:



Trust planning is complex but can be a useful tool in reducing the inheritance tax payable on your estate.

Discretionary trusts

These are where the trustees can make certain decisions about how to use the trust income, and sometimes the capital. Trustees can decide what gets paid out (income or capital), which beneficiary to make payments to and how often payments are made.

Discretionary trusts are sometimes set up to put assets aside for a future need, like a grandchild who may need more financial help than other beneficiaries at some point in their life or beneficiaries who are not capable or responsible enough to deal with money themselves.

Loan Trust

Loan Trusts are for clients who want to start inheritance tax (IHT) planning but can't give up, or feel uncomfortable with losing access to their capital. Using a Loan Trust effectively freezes the IHT problem by allowing you access to your original capital at any point and in any amount but the growth will not be included in your estate for IHT purposes. The outstanding loan remains in your estate for IHT purposes.

Discounted Gift Trust (DGT)

A DGT is an IHT planning arrangement for those individuals who want to approach IHT planning but who are unable to lose full access to their investment. In a DGT, access is provided by a series of pre-set capital payments returned to you as the settlor of the trust. The term "discounted" means that the value of the monies transferred in to the trust is less than the amount invested.

Flexible Reversionary Trusts

These are similar to discounted gift schemes but differ in that the settlor can ask the trustees to defer their entitlements from vesting and maturing assets, which is why the trusts are referred to as being 'flexible'.

Pensions

Pensions can be an effective way of passing on your wealth tax efficiently to whom you nominate, as most pensions allow anyone to inherit your pension. A more detailed explanation is further on in this brochure.

Insuring the liability

Whole-of-life insurance is a type of life insurance policy which ensures that, no matter when you die, your loved ones will receive a lump sum payout from your insurer. One of the big selling points for whole-of-life insurance is that it can help your family deal with an inheritance tax bill. The payout provides the funds needed to clear the inheritance tax bill without needing to take out a loan or dip into their own savings.

Whole-of-life insurance is generally a more expensive form of life cover than term life insurance or family income benefit insurance, for the simple reason that insurers know they will definitely have to pay out some money at some point.

Business Property Relief

Business Property Relief ("BPR") reduces the value of relevant business property for IHT purposes by applying an exemption to the value of the assets in the estate. Relevant business property, together with the rate of relief that applies to those assets, shown in the following table:

	Rate of Relief %
A business or an interest in a business, for example a sole trader or partnership	100%
Shares in unquoted shares trading companies, including shares listed on the Alternative Investment Market (AIM)	100%
Quoted shares which give control of the company	50%
Land or buildings, machinery or plant used wholly or mainly for the purposes of the business carried on by a company controlled by the individual or their partnership	50%

Qualifying Businesses:

One of the conditions for BPR is that the business must not have the majority of its activities from one of the following:

- Dealing in stocks and shares;
- Dealing in land and buildings; or
- Making and holding investments

In other words, more than 50% of the business activities must be of a trading nature. There are a variety of tests that must be considered when reviewing your business interest or shares to ensure that they meet this test, which examines various aspects of the business, including the assets it holds and the income it derives from those activities. A good example of this is the holding of furnished holiday property, which is regarded as a trade for income tax but not regarded as a trade for IHT. Therefore, if your business holds a mixture of assets, including trading assets and/or property we would suggest that you review its overall activities in order to protect any future BPR claims.

Excepted Assets:

Even where BPR is available it may still be restricted where the value of certain assets owned by the business are not used for business purposes. Commonly this will include:

- Excess cash not required for the future of the business;
- Investments held by the business; and/or
- Property not let on a commercial basis.

This can affect the amount of relief that you can obtain so again reviewing your business can ensure you qualify for this important relief

Pensions and Inheritance Tax

Pensions can be an effective way of passing on your wealth tax efficiently to whom you nominate.

The way you take your pension will affect how you can leave it to your beneficiaries (the people who inherit it) when you die. Most pension options allow anyone to inherit your pension – they don't have to be your spouse or civil partner. Make sure your pension provider has up-to-date details of your beneficiary(s). If you have more than one pension, let all your providers know.

If you die and you've not taken an income from it:

A defined contribution pension, which is the case for most workplace pensions and all private pensions, is a pension that's based on how much has been paid into it. The pension provider will normally pay the value of your pension pot in a lump sum to your dependants. If you die before age 75, benefits under money purchase schemes can usually be passed on to your beneficiaries free of income and inheritance tax.

A defined benefit pension — a pension that's based on your final or average salary and the length of time you worked for the employer — will usually pay a pension to your spouse or partner. It may also pay a pension to your children until they leave full time education. The pensions paid to dependants are usually less than the pension you would have received.

If you die while receiving income from a pension drawdown contract, your dependants typically have 3 options:

1. If you're under 75, any drawdown benefits can usually be passed on as a lump sum free of tax. If you are 75 or older, your dependants will have to pay income tax at their marginal tax rate on what income they receive.
2. They can continue the drawdown and carry on taking an income from it. If you are 75 or older they'll pay income tax on what they receive.
3. They can use the remaining fund to purchase an annuity. If you are 75 or older, your dependents will have to pay tax on what they receive.

The key here is that all pension pots are not subject to inheritance tax when you die. If your estate is large enough to be potentially subject to inheritance tax, you may be able to use your pension to reduce or even eliminate your inheritance tax bill.

Further specialist areas for some people to consider

Family Investment Company (FIC)

A Family Investment Company (FIC) is a bespoke vehicle which can be used as an alternative to a family trust. It is a private company whose shareholders are family members. A FIC enables parents to retain control over assets whilst accumulating wealth in a tax efficient manner and facilitating future succession planning.

The key benefit is that you can pass down wealth without an immediate inheritance tax charge, as a FIC is in a corporate structure it comes under corporation tax rules rather than income tax rules in a trust.

Agricultural Property Relief

Agricultural property qualifies for a valuable relief from IHT. Agricultural Property Relief (APR) can give 100% exemption subject to the following conditions:

- The property needs to have been owned for the qualifying period, or to have replaced other agricultural property. The qualifying period is two years if the land is farmed by a business run by the landowner, their partnership or company. This increases to seven years if the land is farmed by any other person.
- The property must be occupied for the purposes of agriculture. This means that houses occupied by non-farmworkers, buildings rented out for non-agricultural use, and land used for grazing horses are examples of assets that do not qualify for relief.
- APR is restricted to the agricultural value of an asset, which is the value if the asset can only be used for agricultural purposes. Examples here include land with development potential and buildings suitable for residential conversion.
- Farmhouses cause a particular problem, as they need to be occupied by a working farmer. HMRC may challenge APR for farmhouses occupied by elderly farmers, and relief may be lost if the individual has to go into a care home. It is also common for HMRC to argue that up to 30% of the value of a farmhouse is non-agricultural.
- Diversification projects will normally mean that agricultural land and buildings cease to be used for agricultural purposes. This will mean they cease to qualify for APR, and it is necessary to see if Business Property Relief is available.

The rules around IHT can be complex, and the amount of tax, and even the overall rate that will be paid, will depend on how your finances are structured during your lifetime, how you dispose of your assets and to whom you leave them. Seeking independent tax and financial advice can help you pass your assets to the people you want to benefit and potentially mitigate some or all of the IHT liability. With the right planning and support some of the IHT receipts currently payable by individuals are thereby able to be legitimately avoided or reduced.

Woodlands Relief

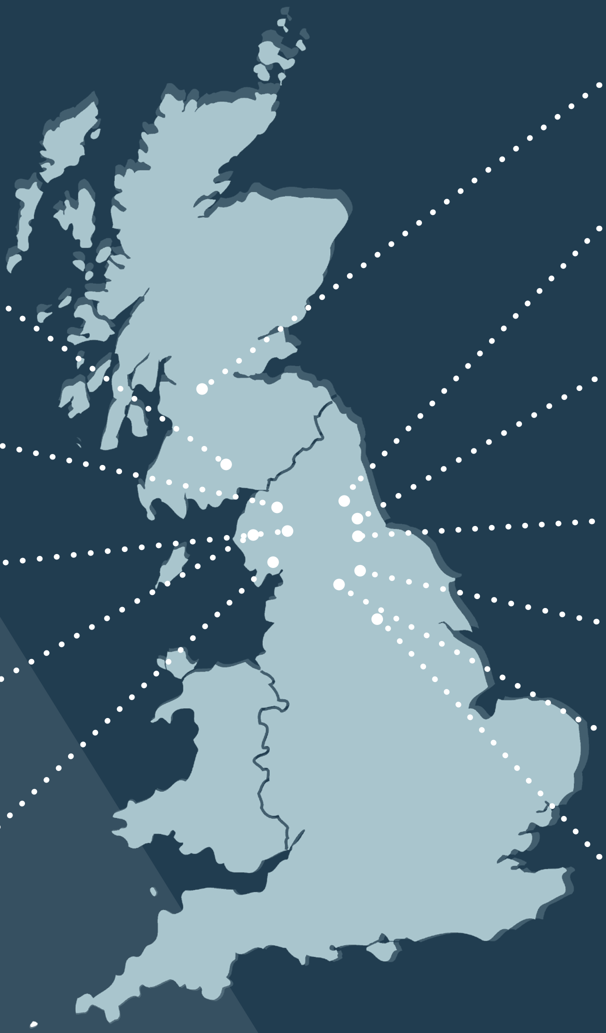
There are three options for Inheritance Tax relief for woodlands:

- Agricultural Property Relief may be claimed for small areas of woodland such as shelter belts which are ancillary to agricultural activities.
- Where the woodland is managed commercially, 100% Business Property Relief should be due after two years of ownership.
- If neither APR or BPR is available, then woodlands relief may be claimed. It is important to note that this is only available on the value of growing timber, and merely defers the Inheritance Tax until the trees are sold.

Heritage Assets

Assets with historical, artistic, scientific or architectural interest such as certain land, buildings and works of art can be exempt from Inheritance Tax (and Capital Gains Tax) when they are gifted during lifetime or transferred to beneficiaries on death. This exemption is known as the Conditional Exemption Tax Incentive Scheme.

The assets themselves must meet certain criteria to qualify and the new owner must undertake to look after them, make them available for the general public to view and to keep them in the UK. Should any of these conditions be broken or the asset is subsequently sold, the exemption is withdrawn and inheritance tax must be paid.



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At Armstrong Watson our quest is to help our clients achieve prosperity, a secure future and peace of mind. We provide bespoke tax planning, financial planning and wealth management all under one roof. Please note, advice on IHT related matters could be provided by a mixture of both our financial planning and tax specialists.

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