Gifts: Inheritance Tax Mitigation for High Net Worth Clients

Introduction

As once written by Benjamin Franklin “In this world nothing can said to be certain, except death and taxes.” (Benjamin Franklin 1789 en.m.wikipedia.org). Whilst somewhat of a bleak statement, it is entirely accurate, and can be almost perfectly exemplified under one particular topic known as inheritance tax.

In a world of longer life expectancies and increasing wealth, the ability to mitigate inheritance tax liabilities is becoming ever more valuable, particularly for those who have a high net worth. Many people, however, do not appreciate the importance of effective tax planning until it is too late, particularly if they do not have an understanding of the taxation which is involved.

“Only 4-5% of estates in the UK pay inheritance tax.” (Source HMRC moneyadviceservice.org.uk). Currently the tax-free threshold is £325,000, meaning any estate equalling less than this amount will be exempt from paying inheritance tax. Any assets over this amount are currently taxed at 40%. “This can be quite a dramatic cut; reducing the pay-out your loved ones receive quite significantly but luckily, there are ways to avoid having to pay inheritance tax” (moneyexpert.com no date)

Broadly speaking, there are two overall methods of reducing inheritance tax, and they can be described as per below:

- Organising one’s estate to reduce overall tax liabilities, in the form of gifts, wills and trusts
- Ensuring there is money to cover the liability, in the form of an insurance policy

During this article we will explore various methods by which inheritance tax mitigation can be achieved, using case studies to highlight the advantages and disadvantages of each approach.

Gifts

Reducing the overall size of your estate by giving or ‘gifting’ some of your assets away whilst you are still alive, is one method of reducing the overall inheritance tax due on your death, and there are various ways of achieving this. The first, and probably the most prevalent to consider is gifts made between spouses or civil partners, as transfers made between them, both in life and death are completely exempt from inheritance tax. It is worth noting however, that if the recipient is non-UK domiciled, then the nil rate band of £325,000 applies. Also, those living together but not married, would not be able to benefit from this method.

For example – Assuming Mr Smith and Mrs Smith both reside in the UK, Mr Smith can gift £500,000 of his estate to his wife and no inheritance tax would be payable. However, if Mrs Smith lived outside of the UK, inheritance tax would be paid on the £175,000 which sits outside the nil rate band of £325,000

Small gifts of up to £250 per year will also be exempt from inheritance tax. These gifts can be made numerous times throughout the tax year, as long as they are given to different beneficiaries, without them being added to the value of the estate. It is worth noting, however, that the annual exemption limit of £3,000 applies, meaning any small gift over this amount would in fact be liable for inheritance tax.

For example – Mr Smith can gift a total of £3,000 to his daughter or £250 to each of his 12 Grandchildren, and both would come just under the annual exemption limit.

Although we have already established that gifts are an effective way to reduce inheritance tax liabilities, there is of course a caveat, and that comes in the form of potential exempt transfers. The rules of IHT state that for a gift to be exempt of inheritance tax, the donor must survive for a minimum of 7 years after the gift is made to the beneficiary. If the donor dies within 3 and 7 years of the gift being made, the tax payable is calculated on a reducing scale known as taper relief.

Years between gift and death tax paid

- Less than 3 40%
- More than 3 but less than 4 32%
- More than 4 but less than 5 24%
- More than 5 but less than 6 16%
- More than 6 but less than 7 8%
- More than 7 0%

Furthermore, the ‘gifts with reservation’ anti-avoidance legislation has been put in place to ensure that the donor is unable to continue to gain benefit from any gift given to a beneficiary. The most common example of this would be gifting a house but continuing to live in the property free of charge.

Trusts

Historically, transferring gifts into trusts has been a popular method of mitigating inheritance tax due on your estate. “What this means is that rather than the sum being paid out as part of your legal estate, it goes directly into a trust intended for a specific beneficiary or group of beneficiaries such as your children” (moneyexpert.com no date). Certain legislative changes made in 2006 have since made the rules and fees much more complicated. Like gifts, once assets are placed into a trust, they cease to belong to you. Essentially, when you die, the value of the assets in trust will either not be considered for inheritance tax purposes or charged at a lower amount.

Although there are many types of trusts available, I will touch upon only the most common. It is of course essential to seek professional advice to ensure you understand the complexities of the trust you choose.

Interest in possession trusts essentially provides an immediate transfer of any income generated within the trust to the beneficiary. It is usually the trustee, as opposed to the beneficiary who has overall control of the assets within the trust, and the capital may often be

passed on to different beneficiaries in the future. As per the 2006 legislation regarding trusts and inheritance tax, they are considered to be chargeable lifetime transfers. This means that a charge of 20% is levied on any balance over £325,000 for trusts created after March 2006. This is a popular trust structure for a person who has been divorced and then remarried at a later date.

Example – Mr Smith creates a will which states that all of the shares he owns shall be placed into an interest in possession trust. Upon his death, his second wife, Mrs Smith begins to earn any income generated form those shares and continues to do so for the rest of her life; however, she has no right to the capital. When Mrs Smith then passes away, the trust itself will cease to exist and the capital will pass to her children.

A bare trust (sometimes referred to as a simple trust) works in a slightly different way. The main difference is that the beneficiary of the trust has an immediate and absolute right to both the income produced, as well as the capital. For inheritance tax purposes, once assets are placed into a bare trust by a donor, the assets are henceforth considered to be a potentially exempt transfer. Of course, as per the guidelines of potentially exempt transfers, the donor must survive for 7 years at least to avoid any inheritance tax being due.

Transferring nil rate bands

When it comes to the mitigation of inheritance tax, the biggest benefit to individuals who are married/in a civil partnership is the transfer of unused nil-rate bands. Married people or civil partners have the ability to transfer the remaining percentage of any unused nil-rate band to their surviving spouse or partner, meaning their own estate will be liable for less inheritance tax when they pass away.

Example – Mr Smith passes away and leaves assets worth £700,000, £100,000 of which he leaves to his daughter. The remaining balance of £600,000 is passed to his wife, Mrs Smith. The nil rate band threshold is £325,000. The assets passed to Mr Smith’s daughter would use up approximately 30% of his nil rate band threshold (£100,000 ÷ £325,000 x 100). Assuming that when Mrs Smith dies, the threshold is still £325,000, she would be able to benefit her full threshold amount, as well as the 30% remaining threshold of Mr Smith’s unused nil rate band. Therefore, Mrs Smith’s total nil rate band would total approximately £550,000 (£325,000 + £225,000).

Reliefs

An inheritance tax relief comes into play when there has already been a transfer of some value, but tax is not due on the full amount.

Business relief is available on some qualifying business assets. A 50% or 100% relief may be applied depending on the structure and ownership of the business; however, the property must have been owned by the business for two years prior to any date of transfer for the relief to be acceptable. Businesses that deal primarily in investments (securities, shares or land/buildings) do not qualify for business relief.

Agricultural relief is available in respect of the transfer of agricultural property. For example, a

farm may be passed on and remain free from inheritance tax as long as it meets certain criteria. Such property can be passed on either during the donor's lifetime or as part of the will. Agricultural property can include farmland, farm buildings and woodlands but does not include livestock or farm equipment or machinery.

Woodland relief is available after two years of ownership and management of the woodland as a business, but it only applies to the timber and not the land itself.

As with the other methods of mitigating inheritance tax, reliefs can be both intricate and complicated so it always worth seeking professional advice on the matter.

Charities

Leaving a gift from your estate to charity is one of the more simple and solid methods of reducing inheritance tax liability and is often referred to as a charitable legacy. If the total amount gifted to charity was over 10% of the net estate at death, you could further benefit from reducing the overall rate of inheritance paid on that estate from 40% to 36%.

Example – Mr Smith is a single man and has a net estate worth £525,000 and his daughter will be the sole beneficiary as stated in his will. As the nil rate band stands at £325,000, upon Mr Smith's death, the net estate is £200,000 (£525,000 - £325,000). As this amount is subject to the 40% inheritance tax rate, the estate would pay an inheritance tax bill of £80,000. If, however Mr Smith were to leave 10% of the total net estate (£20,000) to the charity A Dog's Trust, then the estate would only be liable to pay 36% on £180,000. This means that the estate's tax bill will be reduced to £64,800.

Ultimately this does mean that the recipient of your assets will receive less when you die, however it can be a solid way to mitigate the inheritance tax you estate pays, particularly if you feel passionate about a charitable cause.

Life Insurance

The final method we will consider as a technique to mitigate inheritance tax on your estate involves taking out a life insurance policy. This method differs slightly in the fact that it does not directly reduce the amount of tax paid, rather it insures your family against the risk of the actual inheritance tax bill. "It can help protect your home and other assets from having to be sold to pay an IHT bill. This gives you the peace of mind you're not lumbering your friends and family with a hefty tax bill to pay when you pass away" (moneyadviceservice.org no date).

As any such insurance policy could be considered to be part of the estate, for this method to be effective at mitigating inheritance tax, it must be written into trust. As previously discussed, the trust will ensure that the proceeds of the life insurance policy will be paid to your beneficiaries and not be added as part of the legal estate. "Currently, reports suggest that only 6% of all customer's write their life insurance policies in trust and while many have legitimate reasons for not doing so, there are still undoubtedly many who could be benefiting greatly if they did." (moneyexpert.com no date). As a life insurance policy pays out on death, one benefit of this method is that the beneficiaries of the policy will receive the funds relatively quickly.

There are two common types of insurance policy that can be used for the purpose of mitigating inheritance tax and they are known as term insurance and whole of life policies.

Term insurance policies require a premium to be paid to effectively cover the risk of your death for the length of the policy (or term). The policy will therefore only pay out of you die within the term of the policy. The policy can be set up in a way that ensures that the lump sum pay out covers the amount of the expected inheritance tax bill (which is over the nil rate band amount), therefore relieving your beneficiaries to have to pay it from the estate. A further benefit of this policy is that you are only tied into the policy for the duration of the term, and the premiums are mostly fixed for the duration of the policy meaning you will not be faced with any rising costs.

Whole of life policies differ in the fact that they last for the duration of your life, as opposed to just a set term. Similarly, to term insurance, the whole of life policy will pay out on your death to your beneficiaries and will again be set up to pay for most or all of the expected inheritance tax bill on your estate. There are however some disadvantages to this type of policy, namely that the premiums will still be required well into your old age and can become more expensive as you age. Pre existing health problems should also be considered as they may make the premiums more expensive from the outset.

Example - Tom Jacobs is 60 years old. He is a single man with two children and has an estate worth £725,000. Once the nil rate band has been considered at £325,000 this means that £400,000 of Tom’s estate is liable for inheritance tax purposes. As the current rate of inheritance tax is 40% this means that the estate’s inheritance tax bill will be approximately £160,000. Tom does not want his children to have to worry about paying this amount of money from the estate once he has passed so decides to investigate the option of setting up a life insurance policy to cover the risk.

Tom first investigates a term insurance policy. He is offered a 20-year policy which will cost him a fixed premium of £40 per month and offers a total benefit of £160,000 payable upon his death. This policy would be put into trust, meaning that upon his death, the beneficiaries (his children) would be paid £160,000 to cover the inheritance tax bill due on his estate.

Next, Tom considers a Whole of Life policy. Tom is informed that £160,000 can be paid to his children upon his death as long as he pays the required premiums on the whole of life policy. He is advised that these premiums begin at £30 per month, however, may increase as time goes on. He is also advised that he will have needed to reach the age of 95 before the total amount of his paid premiums exceed the payment of the policy benefit of £160,000.

As with most of the methods of reducing inheritance tax liabilities on your estate, life insurance policies can be complicated, more so since trusts also need to be considered in the process. It is, therefore, again advisable to seek professional advice from a financial advisor or life insurance specialist to ensure that all your needs have been considered.