WEALTH MANAGEMENT ALERT

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How your clients may be able to reduce their inheritance tax bill

No one likes to face their own mortality, but clients with more than £900,000 of assets (for couples) or £450,000 (if they are single) should take action if they want to pass as much as possible of their hard-earned wealth on to their loved ones.

Inheritance tax remains a largely voluntary tax – there are a number of legitimate ways clients may be able to reduce their liability or even eliminate it totally. However, it is vital that they take independent financial advice before acting – inheritance tax planning is complex, it is easy to get it wrong and mistakes can prove costly.

Are clients making the most of their various IHT exempt allowances?

The first place to start is with the various allowances available. An individual can give away up to £3,000 each tax year as either one or more gifts, so couples can give away up to £6,000. Any unused allowance can be carried forward to the next tax year. Each individual can also give up to £250 to any number of people other than those who have received part or all of the £3,000 allowance.

They can also make regular gifts from their income, as long as doing this does not reduce their standard of living. This can be very useful, but if the donor pays income tax it is not necessarily the most tax-efficient way of passing on money.

In addition, each individual can give their child getting married up to £5,000, a grandchild or more distant descendent getting married up to £2,500 and a friend or anyone else they know getting married up to £1,000.

Donations to charity, political parties, universities and certain other bodies are exempt from IHT, as are maintenance payments to spouses, ex-spouses, elderly or infirm dependent relatives and children under 18 or in full-time education.

Life cover

Life cover remains a popular option, especially if clients don't want to give away their assets while they are still alive. When they die a life insurance policy can pay an amount equal to their estimated IHT liability. The policy needs to be written in trust in order for the proceeds to fall outside their estate.

Policies can run for a specific term, or for the rest of the named individual's life, with the latter usually preferable for reducing IHT. For couples, policies that pay out when the second person dies can be the most cost-efficient way of reducing their combined IHT liability.

Clients who are in poor health or who are very old may find it difficult to find life cover. There are, however, other ways that they may be able to reduce their likely IHT liability.

Trusts still be effective

Many people would like to give away assets to reduce IHT but are concerned about losing control of the money. This is where trusts can help. Despite rule changes that have made some trusts less tax-efficient, they are still worth considering.

No need to sell the family home

Clients with a lot of their wealth tied up in their main residence and who have income to spare could consider giving away their home, for instance to one or more of their children or grandchildren, continue to live in it and pay the new owners full market rent. If the original owners live for at least seven years after giving their home away and pay the market rent, it will fall outside their estates for inheritance tax purposes. The rental income would form part of the recipients' income and, as such, would be taxed in the usual way.

There are three main types of trusts, in which any number of different types of investments can be held. Clients should take independent financial advice to ensure that they use an appropriate type of trust and that it is set up correctly and reflects their wishes. They also need to make sure that their Will is written correctly and reflects their wishes.

Bare trusts: These are also known as absolute trusts. The beneficiaries are named when the trust is set up and they can't be changed. The assets, both income and capital, are immediately owned by, and can be taken by, the beneficiaries when they reach the age of 18 (16 in Scotland).

Continued on next page

Interest-in-possession trusts: The beneficiaries have a right to all the income from the trust, but not necessarily the capital. For IHT planning purposes, the person setting up the trust might want to receive the income, with the capital going to their beneficiaries when they die.

Alternatively, an interest-in-possession trust could enable the spouse of the deceased to benefit from the income, and the children to own the capital. The trust could be wound up and the capital distributed when the spouse dies.

Discretionary trusts: These are the most flexible form of trust, as they can cater for a group of beneficiaries. The trust deed usually allows the income and capital to be distributed at the trustees' discretion, giving them the option not to distribute income if they so wish. In contrast, an interest-in-possession trust requires the income to be paid to one or more of the beneficiaries. To ensure that the settlor and his or her spouse are not taxed on the income from a discretionary trust, they are not normally beneficiaries.

Some trusts have to pay an IHT charge when they are set up, at 10 yearly intervals and possibly when assets are distributed. For instance, if an individual places more than the current nil rate band into trust, a lifetime transfer tax of 20% is payable on the excess amount.

In addition to potential IHT benefits, trusts can also facilitate CGT rollover and the control of and access to assets, ring-fencing and protecting them from people with potential claims against the settlor and beneficiaries, or people claiming through them, such as former spouses.

Business property relief

Once a person has owned shares that qualify for Business Property Relief (BPR) for two years or more, when they die they can be passed on free from inheritance tax. This enables business owners, investors in businesses not listed on the main stock exchange and people in partnerships to pass on wealth tied up in certain business activities without paying IHT on it.

Investments in businesses that carry on a trade rather that investment activities could qualify for BPR, including shares in qualifying companies that are not listed on a stock exchange, shares in qualifying companies listed on AIM, and interests in other qualifying businesses, such as partnerships.

Stock-market investments IHT-exempt after two years

Clients who do not have business interests of their own could consider investing in AIM-listed or unlisted smaller companies that qualify for BPR. It is possible to hold AIM-listed shares within an ISA, giving them the tax benefits of ISAs during their life, plus the IHT exemption when they die. This could interest clients who risk leaving an IHT liability but don't want to give away large sums of money, those who want to give the inheritance they hope to leave a chance to grow, or people who are older or those in poor health who want the money to become exempt from inheritance tax quickly. Clients interested in this could consider using a specialist discretionary fund manager, or invest via one of the specialist funds that are now available.

However, investments in unquoted companies and those quoted on AIM are considered to be high risk and it may be difficult to sell them quickly. It is important that clients understand the risks that they are taking when making such investments and they should take independent financial advice.

We are experienced in helping individuals and families put in place strategies designed to enable them to pass on as much of their wealth as possible to their loved ones. We would be happy to work with you in the way that suits you best.

To refer clients to us or to discuss how we could work together, email Phil Mason, Business Development Director, LighthouseCarrwood Limited.
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How does the 'main residence' band work?

The 'main residence' allowance, introduced in the 2017/18 tax year, can only, as its name suggests, be offset against a person's main residence and when the person inheriting the home is a direct descendant (children, stepchildren or grandchildren). The allowance, which is in addition to the usual nil rate band, is being phased in as follows:

It started at £100,000 and will rise by £25,000 each tax year until 2020, when it will be worth £175,000.

It is per person, effectively giving couples an additional £250,000 in all now, rising to an additional £350,000 by 2020.

If a property is worth between £1 million and £2 million, inheritance tax is payable as usual on the amount above the allowance.

If a property is worth £2 million or more, homeowners lose £1 of the 'main residence' allowance for every £2 of value above £2 million, virtually negating the allowance on properties worth £2,350,000 or more.