



News letter *1-10-2012*

Seven Financial

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Inheritance Tax Explained

Inheritance tax explained

Inheritance tax (IHT) is a tax on money or possessions you leave behind when you die, and on some gifts you make during your lifetime.

However, a certain amount can be passed on tax-free, which we call the 'tax-free allowance'. This is also known as the 'nil rate band'.

Everyone in the 2011-2012 tax year has a tax-free inheritance tax allowance of £325,000. The allowance will remain the same until 2015.

There are also a number of gifts that you can make during your lifetime or in your will that are also tax free and these are covered later (see Inheritance tax planning and tax-free gifts).

Inheritance tax thresholds and rates

If you are single and die during the tax year with an estate worth more than £325,000 (including money, property and investments, but after deducting debts and expenses such as funeral costs), 40% tax will become due on anything above £325,000.

For example, if you leave behind an estate worth £525,000 the tax bill will be £80,000 (40% on £200,000 – the difference between £525,000 and £325,000).

However, if you are married or in a civil partnership, you may be able to leave more than this before paying tax.

New inheritance tax rules for married couples and civil partners

Married couples and civil partners are allowed to pass their possessions and assets to each other tax-free and, since October 2007, the surviving partner is now allowed to use both tax-free allowances (providing one wasn't already used at the first death).

At the extreme, this effectively doubles the amount the surviving partner can leave behind tax-free without the need for special tax planning.

However, some people whose partner died before 21 March 1972 will be caught by a loophole.



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Making a gift

As well as on your estate at death, inheritance tax may also be payable on gifts you make during your lifetime, especially if you die within seven years of making the gift.

Gifts fall into four basic categories:

Category 1 Gifts always tax-free

- Gifts between a husband and wife or civil partners who are both domiciled in the UK. Where the transfer is from a party domiciled in the UK to a partner domiciled abroad, only gifts up to £55,000 are exempt.
- Gifts to UK-established charities, national museums, universities, the National Trust and certain other bodies. Gifts to political parties (broadly those represented in parliament with at least two MPs). Gifts to registered housing associations and community amateur sports clubs.
- Most gifts to people made more than seven years before your death. They must be to people as opposed to trusts or businesses.
- Gifts made as part of your 'normal expenditure'. This exemption allows you to give away money from surplus income, providing the gift doesn't reduce your standard of living, is not from capital and forms some pattern of regular spending. A good test is if the money comes from your current account.
- Gifts to people getting married. Up to: £5,000 from each parent of the couple; £2,500 from each grandparent or more remote relative; £2,500 from bridegroom to bride (and vice versa) and between civil partners; £1,000 from anyone else.
- Any number of gifts up to £250 to each recipient. These gifts are meant to cover things such as birthday and Christmas presents.
- Gifts for maintenance of husband, wife or civil partner, ex-husband, ex-wife or ex-civil partner and relatives dependent on you through old age or infirmity. And for maintenance, education or training of your children (including step and adopted children) in full-time education or aged 18 or under.
- Gifts up to £3,000 in total in each tax year you cannot combine these with a £250 gift to the same person. Husbands, wives and civil partners each have £3,000 limit. You can carry any unused part forward one year only, to the next year. This gift is known as the 'annual exemption'.



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Category 2 Gifts that might be tax-free

Most gifts you make to other people during your lifetime (unless they fall into the list of tax-free gifts) are classified as 'potentially exempt transfers' or PETs for short.

If you survive for seven years after making the gift, no inheritance tax is due. However, if you die within this time, two things happen.

(A) The PET is reassessed

The PET is reassessed and added to any other taxable gift. You may have made in the seven years before making the PET. This has to happen to see whether any tax is now due on the PET itself. This means that gifts made during the 14 years before death could be relevant.

If tax does become due on a PET, the person who received the PET will be asked to pay the tax. However, the tax due may be reduced because of 'taper relief'.

This is how taper relief can reduce tax due on PETs:

If the gift was made less than three years before death, no reduction in tax is due

If the gift was made three to four years before death, tax is reduced by 20%

If the gift was made four to five years before death, tax is reduced by 40%

If the gift was made five to six years before death, tax is reduced by 60%

If the gift was made six to seven years before death, tax is reduced by 80%

If the seven-year running total of taxable gifts and PETs made comes to less than the tax-free allowance (at the date of death), no tax will be due on the PET.

While taper relief may reduce tax on PETs if you die within seven years of making them, it won't reduce the tax due on your estate.

(B) The PET is added to your estate

The second thing to happen if you die within seven years of making a PET is that the PET is also added to your estate to work out how much tax is due on the estate. If the seven-year running total of PETs, chargeable gifts and your estate comes to less than the unused tax-free allowance, no tax will be due.

However, if much of the tax-free allowance has been used up against PETs and taxable lifetime gifts, this can leave little or no allowance to be used against the rest of the estate.



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Category 3 IHT taxable gifts Taxable, but no tax due at the time the gift is made.

Some gifts are taxable unless you live on for seven years.

Some gifts are taxable at the time you make them. These are mainly gifts to companies and to the trustees of most types of trusts. Read the HMRC guide to trusts and how they work.

However, you won't have to pay tax on these gifts at the time you make them if the running total of all the taxable gifts made in the previous seven years comes to less than the tax-free allowance (see Inheritance tax: thresholds, rates and who pays).

Example: below threshold

If Iain Fleming puts £250,000 into trust in May 2010, having made no other gifts during the previous seven years, the gift is technically taxable because it's made to a trust and not an individual. However, the amount is less than the current tax-free allowance of £325,000 so no tax has to be paid.

However, if Iain died within seven years of making the gift, the tax-free allowance that would be applied to his estate would be reduced by the amount of the gift, ie £325,000 - £250,000 = £75,000. Only £75,000 would therefore be applied against the rest of the estate.

Example: above threshold

If Iain had made a previous gift of, say, £250,000 to the trust in 2004, his total taxable gifts during the seven years to May 2010 would come to £500,000 and he would have had to pay IHT on anything over the tax-free allowance. In this example Iain would have to pay tax on £175,000 (£500,000 - £325,000).

If tax becomes due on a lifetime gift, it's paid at half the normal rate – so currently 20%. In our example Iain would pay tax of £35,000 (20% of £175,000).

If you die within seven years of making the gift it's reassessed at the death rates, so there is likely to be more tax to pay.



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Category 4 IHT taxable gifts Taxable, and tax is paid at the time the gift is made.

Some gifts are taxable unless you live on for seven years. To repeat.

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What are the reliefs available?

There are certain reliefs available which will reduce the IHT bill.

1 Taper relief on PETs

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

2 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 for agricultural purposes. It doesn't include livestock, dead stock or farm implements but these may qualify for business property relief (see below).

3 Business Property Relief

There is 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 worth investing in.

4 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 underwood) but not to the underlying land. However the land could benefit from agricultural or business property relief.

5 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 first death with a sliding scale relief up to a 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%



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Who pays the inheritance tax bill?

Inheritance tax that becomes due on money or possessions passed on when you die is usually paid from your estate. Basically your estate is made up of everything you own, minus debts such as your mortgage and expenses such as funeral expenses.

However, if the tax is due on gifts you made during the last seven years before your death, the people who received the gifts must pay the tax due.

If they cannot or will not pay, the amount due then comes out of your estate.

Domicile who pays IHT?

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. It is important to note that even if you are not domiciled in the UK, any assets held in the UK will be subject to IHT.

What is transfer of value?

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. Transfers of Value can be categorised as a Lifetime Chargeable Transfers, Potentially Exempt Transfers or Exempt Transfers.



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What are gifts with reservation?

Although gifting property can be a useful tool in reducing your IHT liability you must ensure that any gift 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 case 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

Bryan's mum gifts flat to Bryan 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 Bryan's mum's death as the gift was with reservation the flat will be deemed to be part of her 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, Bryan's mum 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 Bryan's mum'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 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.



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What about 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 around £10,600. 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 so that there are only certain types of assets that will qualify for its use.

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



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How do Trusts Work?

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

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 e.g. 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 grandparents to set up such a Trust for the benefit of their grand-children. After The Finance Act these Trusts are no longer “favoured” and are taxed as discretionary trusts.

Trusts created on death by a parent to provide for their children until they reach the age of 18 and Trusts created for the benefit of a disabled person during lifetime or on death remain “favoured Trusts” and do not attract IHT.

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 are discussed later in this news letter. 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.

NRB Discretionary Trusts

In the past setting up a NRB Discretionary Trust was an extremely effective way for 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 and need to be reviewed in light of changes in legislation.

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.



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What are Lifetime Chargeable Transfers?

Tax is payable on 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 rules on how IHT are calculated on gifts to a discretionary trust are 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. For simplicity reasons we can say that the rate will currently not exceed 6 %

Useful Link

Some gifts are taxable at the time you make them. These are mainly gifts to companies and to the trustees of most types of trusts. Read the HMRC guide to trusts and how they work. The link is attached below.

<http://www.hmrc.gov.uk/trusts/iht/index.htm>

At Seven Financial we are here to help.

Please contact the team.