

Dealing with Inheritance Tax (Part 3)

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This Guide gives outline details of the main investment products that can be used to reduce the Inheritance Tax due on your estate.

It should be read in conjunction with Part 1, which deals with what Inheritance Tax is, whether it will affect you and your family and the main exemptions and reliefs.

Part 2 of this Guide provides some do's and don'ts when dealing with Inheritance Tax.

Background

This part of our Guide deals with the range of investment products that can be used to reduce your likely Inheritance Tax (IHT) bill. However, it may not be necessary for you to use any of these because it may be appropriate for you to simply pass your assets to the next generation(s) as a series of outright gifts.

Provided that such transfers are covered by one or more of the IHT exemptions, or you live for a further seven years after making the transfers, then you will have dealt with your potential IHT problem in an efficient and extremely cost effective way.

For many people, however, it will just not be possible to give away enough of their estate to remove the whole of the potential IHT bill and for such people this part of the Guide offers a series of alternatives.

"You must pay taxes. But there's no law that says you gotta leave a tip"

Morgan Stanley (US Advertisement)

Use of Life Assurance

Depending on your state of health, you could consider taking out a life assurance policy. This would, of course, need to be put in trust from the outset, or the sum assured would merely add to the value of your estate on your death.

As premiums on a life assurance policy are normally paid monthly they ideally suit the 'gifts made out of income' exemption. As the sum assured would be paid to the trustees on your death this would be free of any liability for Inheritance Tax.

Although the premiums for such a policy could be high, depending on your age, this method is used quite commonly for putting capital in the hands of beneficiaries free of IHT. The sum assured is frequently set as the amount of IHT liability on the estate but even a smaller amount could still make things easier for your beneficiaries.

Using a **Flexible Whole of Life Plan** under trust would provide the following benefits:

- on your death, **the policy proceeds would be paid to the surviving trustees on production of a death certificate**. It is not necessary to wait for your personal representatives to produce a grant of probate.
- the policy proceeds can **be used to pay part of the IHT bill** that is received from HM Revenue & Customs.
- the **policy proceeds do not get added to your estate**.
- the policy would do the job it was meant to do **even if you died shortly after the policy were in force** and had only paid one annual or a few monthly premiums.
- although the premiums would be considered as a gift for IHT purposes, their regular nature would allow them to be **covered under the 'gifts made out of normal expenditure' exemption**.

Example of making use of Life Assurance for Inheritance Tax planning

Mr and Mrs Smith are both aged 64, are in good health and have a potential IHT bill on their estate of £250,000 when the survivor of them dies. They feel that they are too young to pass assets to their children but are concerned about the tax bill their children would face if they were both to die early on.

For an annual premium of £4,189 they could set up a whole of life policy with guaranteed premium rates that would pay out £250,000 when the second of them died. A lower premium could be obtained for a flexible whole of life policy with premiums reviewable at set intervals.

For the sake of simplicity it has been assumed that neither the premiums nor the sum insured will increase with inflation although we would recommend setting the plan up on an inflation-linked basis.

If death of survivor occurs at his/her age	Total premiums would be	Sum insured	Financial benefit to family
69	20,945	250,000	229,055
74	41,890	250,000	208,110
79	62,835	250,000	187,165
84	83,780	250,000	166,220
89	104,725	250,000	145,276
94	125,670	250,000	124,330
99	146,615	250,000	103,385
104	167,560	250,000	82,440

The benefit of such life assurance is best seen when the death of both Mr and Mrs Smith occurs in the earlier years of the policy. However, even in the later years there is still a substantial financial benefit to the family.

Even if one of them were to live until they were 120 years old and pay as much in premiums as the sum insured they would still have achieved the movement of £250,000 from their taxable estate into a non-taxed lump sum in the hands of their beneficiaries.

Figures from *The Exchange* 11.08.2011

Use of an Estate Planning Bond

There is a number of estate planning bonds available from insurance companies. They all involve making an investment into a single premium life assurance bond, often referred to as a capital investment bond.

"Estate taxes are not really taxes but penalties imposed on those who neglect to plan ahead or who retain unskilled estate planners."

Henry Aaron and Alicia Munnell

The Gift Trust

This is simply a means of making an outright gift into a trust, with the beneficiaries being, say, your children or grandchildren.

The money is invested into a capital investment bond, which, because it does not produce income, is much simpler for the trustees to administer than leaving the money on deposit or buying shares because of the tax implications and record keeping required.

Under this scheme you would have no access to the bond but the gift could be treated as a potentially exempt transfer (PET) if a bare trust is used. A gift trust should only be used where you can give away capital without needing to live on the income that it was producing.

The IHT Discount Scheme

This is a means of making an outright gift into trust for the benefit of younger members of your family. This scheme would provide you with an income and an immediate reduction in your potential IHT liability.

If you survive more than seven years after making the investment, all the benefits are free of IHT. However, even if you were to die soon after setting up the scheme there would still be a reduction in IHT to be paid depending on your age.

The Loan Trust

This scheme sets up a loan from you to a trust which the trustees then invest into a capital investment bond. The trust would again be for the benefit of younger members of your family.

The trust would repay 5% of the money loaned to it each year which would act as an 'income' for you. In the meantime all the investment growth on the bond would be in the trust and therefore outside of your estate.

This type of scheme is not suitable for very elderly clients, as it ideally needs to be in force for a number of years before any benefit is gained from the growth on the investment that will be occurring outside of your estate.

The Wealth Creation Plan

This scheme is effectively a life assurance plan as described earlier but instead of making monthly premiums, a single premium is paid into the plan at the outset, which is again set up under trust.

Use of an Estate Planning Investment

One unit trust company has now set up a scheme which is similar to that used for many years by insurance companies. The difference is that the underlying investment is a managed portfolio of unit trusts rather than a single premium life assurance bond.

There are advantages and disadvantages of using this approach and we would be happy to discuss them with you.

Use of an Annuity

You could purchase an annuity (ie a guaranteed income for life). This would have the effect of immediately reducing your estate by the amount of the purchase price because an annuity would cease on your death (apart from any remaining guarantee period) and no value would be added back to your estate.

Whilst the idea of reducing your estate might be attractive, many people are put off using annuities because they feel that on their early death the insurance companies will keep their money.

However, annuities can be set up with a 5 year or even 10 year guarantee which means that either you or your beneficiaries will receive the income for at least this period.

Annuities can also be set up on a 'joint life, last survivor' basis so that the income is paid at the same, or a reduced, amount on your death to your spouse, should you die before him or her.

You would, of course, have to spend the net annuity income each year, or give it away under one or more of the exemptions, or it will simply build up in your bank account and defeat the object of the exercise.

Use of an Immediate Care Plan

The cost of care in later life, whether at home or in a residential care home, can quickly reduce an estate. However, it is possible to pay a single premium so that an insurer will guarantee to pay a certain level of care fees for the rest of your life.

This works in a similar way to an annuity in that a lump sum is paid to an insurance company and is removed from your estate.

Use of an Investment in AIM

This estate planning measure involves investing some of your estate in the Alternative Investment Market (AIM). Any money invested in AIM listed companies falls outside of your estate for IHT purposes after just two years. Furthermore, unlike many other solutions to IHT, you retain access to your money at all times.

Such an investment is very high risk and that fact alone will mean that it should not be considered by the majority of people seeking to reduce the impact of IHT for their beneficiaries.

On the other hand, if you do nothing, 40% of your estate in excess of the nil rate band is certain to be paid to the Revenue rather than your chosen beneficiaries.

It would be difficult to invest directly into AIM stocks with a view to obtaining exemption from IHT because the rules as to which stocks qualify for business property relief are complex. The solution is to use one of the professional management services that are available.

Examples of investors who could make use of AIM stocks for IHT planning

Elderly individuals who have **built up large ISA portfolios** and who are not needing income can sell all or part of their ISA portfolio tax free and invest into an IHT AIM portfolio.

Individuals whose **life expectancy is short** but likely to be longer than two years.

Younger individuals with access to capital who **start an IHT AIM portfolio with a modest amount** taking a long term view, in the expectation of significant capital growth.

For further information on using a portfolio of Aim stocks as part of your estate planning see our Guide: *Using AIM Stocks in IHT Planning*.

Use of Equity Release

You might want to use one or more of these investment ideas to reduce the IHT on your estate, but your estate is mainly made up of the family home and not much in the way of capital that can be invested.

Of course, the ability to use both nil rate bands on the death of the second spouse will potentially move a lot of people out of IHT because there is an effective nil rate band of £650,000 (ie 2 x £325,000).

Particularly in London and the South East, however, it is quite common to find that your family home is valued at well in excess of £600,000.

Of course, a simple solution which many older clients take is to 'downsize' their family home and release capital which can then be given to, or invested for, the children or other heirs.

There are many reasons why moving home may not be appropriate in your case. In such a situation there is still an alternative to owning the home until you die and passing 40% of your estate to HM Revenue & Customs. This is where some form of 'equity release' comes into its own.

An equity release is simply a method of taking out a mortgage on your home under special conditions. The usual income requirements are waived, you simply have to be old enough to qualify.

The capital released from the home can then be given to the children or invested in some form of IHT planning investment.

Example of using equity release for IHT planning

Mrs Smith is a 78 year old widow who lives in an £800,000 house from which she does not want to move. She is fit and healthy. Mrs Smith wants to reduce the IHT burden that her children will face but she needs all of her investments to provide income to her.

With the full involvement of her three children Mrs Smith decides to release £300,000 from the equity in her house. She then has a number of options to reduce the IHT on her estate:

(1) **Give £100,000 to each of her children** which will be out of her estate after 7 years (well within the average life expectancy for a 78 year old).

(2) **Invest the money into one or more estate planning bonds** which will have the same effect as (1) but let Mrs Smith still control the money. If need be these can be arranged to provide additional income to her.

(3) Depending on her attitude to risk and that of her children she could **invest some of the capital in AIM stocks which will be out of her estate after just two years** but still remain in her control while she lives.

(4) Mrs Smith could use the released capital to **purchase an annuity**. This, combined with the mortgage, would immediately reduce the value of her estate but would also, of course mean less money would go to the children on her death.

(5) Mrs Smith could **purchase a second property** (possibly a holiday home) in the names of her three children. This would be out of her estate after 7 years.

There are other ways that the released capital could be used. The point about using equity release is to introduce some flexibility into the situation so that IHT planning can be carried out.

Use of Stakeholder Pensions

This is a type of private pension arrangement that the Government introduced with effect from 6th April 2001. The important point as far as our present objective is concerned, is that there is no link between earnings from employment or self-employment and a person's ability to contribute to what is effectively a personal pension plan.

Furthermore there is no minimum age limit to own a stakeholder and no restriction on someone else setting one up on your behalf.

Basic rate tax relief is given at source irrespective of whether the person whose name the stakeholder is in has earnings that are liable for tax or not.

The maximum contribution that can be made on behalf of any one person is £3,600 gross (ie £2,880 net of basic rate tax) in a tax year without any need to show 'relevant earnings' from employment or self employment.

With more capital passing through the generations, many well-off grandparents are reluctant to pass too much capital to their grandchildren when they are just starting out in life because it can have a detrimental effect.

As they are regular, the contributions to the Stakeholder Pensions may be covered by the 'gifts out of income' exemption. Even if they could not be treated in this way they would still be PETs with the possibility of a reduction in the IHT liability after three years.

Even if you died soon after setting up one or more stakeholder pensions for younger members of your family, the availability of 20% tax relief at source on each contribution would effectively halve the IHT that would otherwise be due on these amounts.

For further information on Stakeholder Pensions see our Guide: *Stakeholder Pensions*.

References to married couples in this Guide should also be taken to include those in registered civil partnerships.

Please note that this information does not constitute personal advice and should not be treated as a substitute for specific advice based on your circumstances. Any information given in this Guide relating to inheritance tax legislation is based on our understanding of legislation and practice in force at the date of this Guide and this is not intended as a definitive listing of the rules governing inheritance tax. Whilst we believe our interpretation of current law and practice to be correct in these areas, we cannot be responsible for the effects of any future legislation or any change in interpretation or treatment.

In particular you are warned that levels of tax and tax reliefs that may have been referred to, are subject to alteration and, in any case, the value of such reliefs and benefits may depend on an individual's circumstances. You should not take action on your estate without talking through your personal situation with an independent financial adviser, such as ourselves, or your Solicitor.

For personal advice

If you would like to receive advice on your personal inheritance tax situation or any issue that has been raised by these notes please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**
or **01483 204600** (if local)
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**



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