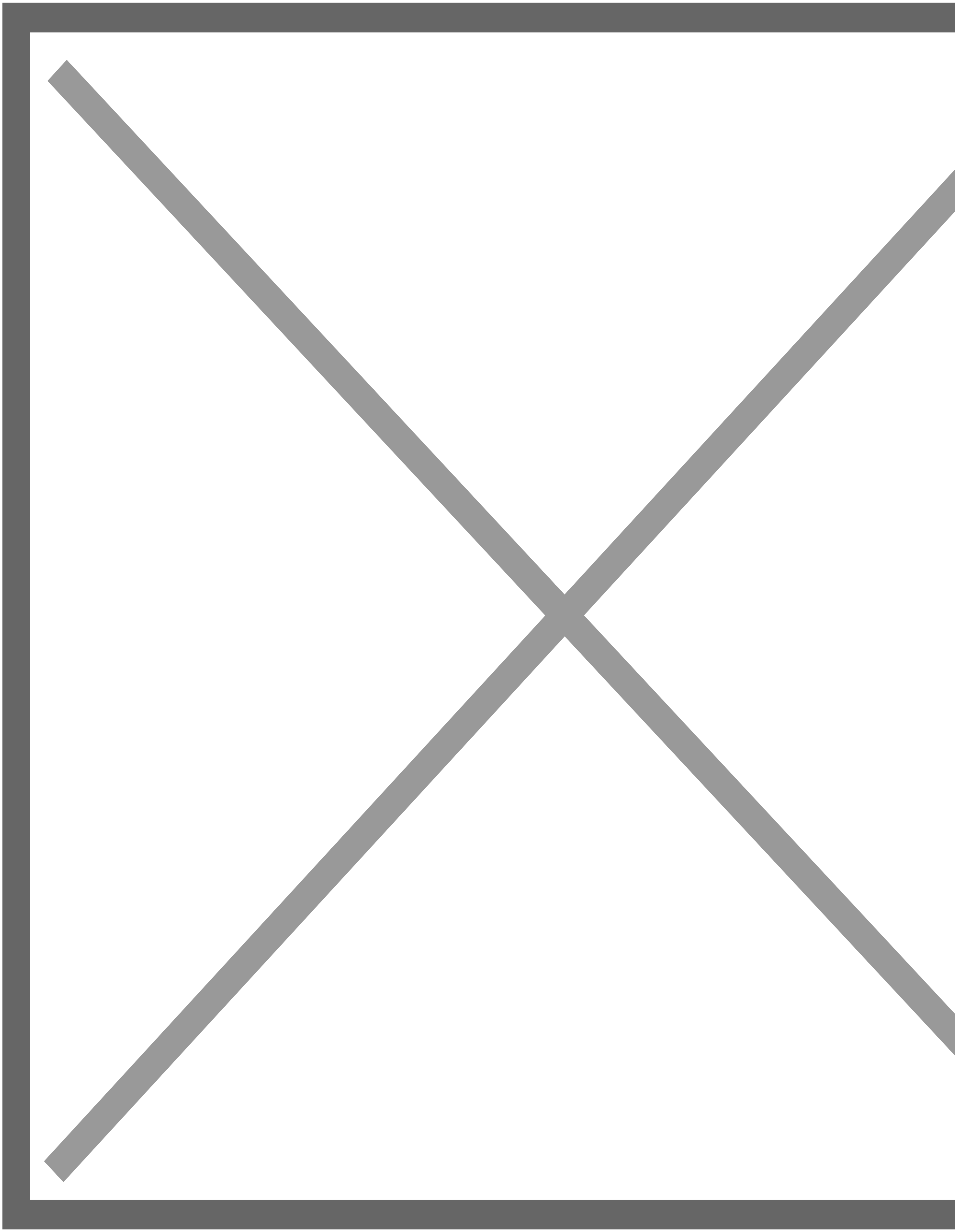
The gift of protection

Inheritance tax and trusts



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John Bunker and Kirstie Williamson consider how to best advise your clients on their options to mitigate their exposure to inheritance tax

Key Points

What is the issue?

Lifetime giving should be one of the most straightforward and least contentious weapons in the planner's armoury but as the rules stand it can be surprisingly complex, with the rules and limits for each of the gift exemptions.

What does it mean for me?

Will drafting is a major element in inheritance tax planning. The use of variations of estates or trusts within two years of death has become ever more important with changes to inheritance tax.

What can I take away?

Clients need to be made aware of options and potential variations, with great opportunities for advisers to show they are adding value by illustrating benefits that could flow from an optimal arrangement.

In July 2019, the Office of Tax Simplification (OTS) released its second report on simplifying the design of inheritance tax (see bit.ly/3qe8jsA). The report explores the main complexities and technical issues that arise from the way the tax works, making recommendations which could streamline gift exemptions, change the way the tax works in relation to lifetime gifts to make it both simpler and more intuitive, and address distortions in the operation and scope of reliefs such as those for business property and agricultural property.

Whilst none of its recommendations have yet been implemented, with the disruption of Covid-19 preventing any tax changes, they cannot be overlooked when advising clients on their options to mitigate their exposure to the tax.

The two following articles by Kirstie Williamson and John Bunker aim to look at the current position with regard to some 'standard' available planning tools for the tax advisor, starting with lifetime gifting, and going on to will drafting, considering the impact of some of the OTS's proposed changes.

Lifetime gifts

Kirstie Williamson considers the rules relating to lifetime gifts

Lifetime giving should be one of the most straightforward and least contentious weapons in the planner's armoury but as the rules stand it can be surprisingly complex, with the rules and limits for each of the gift exemptions.

The annual exemption is frozen at £3,000 per donor (i.e. per person), and making the gift is seemingly simple. However, this still causes frequent confusion amongst clients, who often take the exemption to be available per recipient. It is important that this is explained, along with the facility for any unused exemption to be carried forward one tax year only – meaning that a couple who have not previously used their exemptions could make gifts of up to £12,000 in a single tax year.

The OTS suggested increasing this exemption, as it has been frozen for nearly 40 years, making it far less valuable than in 1981 when the average annual wage in the UK was £6,000!

The exemption is useful but makes little dent in the inheritance tax liability of many.

Gifting from income

Gifting from income (the normal expenditure out of income exemption) can be very beneficial for those who do not spend all their earnings or pension and whose surplus income would only augment their capital and thus their inheritance tax problem. This can be a very generous exemption, as it is effectively unlimited provided that two main requirements are met.

Maintaining records

The first requirement is that the donor keeps sufficient records to evidence the available surplus. In practice, giving clients form IHT403, with encouragement to keep records of income and (especially) expenditure by tax year, as required, can avoid problems for executors. Reconstructing expenditure can be extremely difficult, which is not helped by the fact that banks generally don't keep records for more than six years, making reconstructing the full seven year financial history very difficult.

Executors tasked with completing the form retrospectively can find this a frustrating and time intensive process, which may be for little gain if the donor has inadvertently gifted more than they intended and the gifts are ultimately disallowed. In particular, capital withdrawals from investment bonds (the so-called tax free 5%) are not regarded as 'income' by HMRC but as returns of capital. They therefore cannot be taken into account, catching out many clients who consider their monthly withdrawal from their bond to be 'income'.

Regularity of payments

The second requirement for the 'normal expenditure' exemption is showing the regularity of payments or the commitment to go on making the payments.

It helps to have a letter or note signed by the donor confirming their intention to continue payments of school fees, mortgage, the monthly allowance or other commitments. The amount gifted doesn't have to be the same each time, but the principle of paying will suffice (for example, a commitment to pay school fees each term).

Some clients can gift from cash bonuses, if they live off their monthly income and the bonus is entirely surplus; for example, if this is supported by a signed note committing your client to gift the full bonus each time. Gifting can be to a trust for grandchildren, in addition to the £325,000 nil rate band, without any tax charge if the figures are justified.

Potentially exempt transfers

Potentially exempt transfers (PETs) are a familiar way to make more substantial gifts, though again the rules surrounding them are often poorly understood by the tax paying public.

Many are not aware that the recipient pays the tax on ‘failed’ PETs when the donor dies within seven years of gifting. The taper relief rules are famously misunderstood. The taper reduces only any tax payable on the gift, not the amount of it, with no saving if the gift bears no tax because it is within the nil rate band.

Advisors often see cases of parents making similar sized gifts to two or more of their children a couple of years apart; for example, to fund a house purchase. However, if the parent dies within that seven year period, the nil rate band is applied entirely against the earliest gifts, allowing some gifts to be tax free whilst others are taxed in full. This is rarely the intention of the donor and is not expected by the recipient, and such eventualities can result in enormous family friction.

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The OTS proposed simplifying the regime, abolishing some exemptions in return for an increased annual exemption, the abolition of taper relief and reducing the survivorship period from seven to five years to assist record keeping. Such changes would help people to understand the rules and make them less vulnerable to trip over their complexities. Meanwhile, make the most of the current exemptions while we have them, especially gifts from income that looks most vulnerable to change.

Tax planning through wills and variations

John Bunker examines how to use clear tax planning, rather than more questionable tax avoidance

Will drafting is a major element in inheritance tax planning. The use of variations of estates (Inheritance Tax Act (IHTA) 1984 s 142) or trusts (s 144) within two years of death has become ever more important with changes to inheritance tax, especially the residence nil rate band, and many wills need review to make the most effective use of this. At a simple level, this includes trusts for grandchildren, which may operate as relevant property trusts because of a contingency such as attaining the age of 18 or 21, being varied by an advancement to an immediate post death interest trust or bare trust, read back under s 144.

Wills for spouses

Wills for spouses reach a more complex level of planning options, including variations, with the objective to offer clients the opportunity to optimise the use of these key elements of inheritance tax. (Clients are free to take up these options, or reject them if they don’t wish to incur the greater costs.)

Spouse exemption: Spouse exemption, by an outright gift or immediate post death interest trust, is invaluable in the right circumstances; however, it will be better to consider using the nil rate band as set out below.

The OTS proposals (made in its July 2019 report, and repeated in its first Capital Gains Review in November 2020) to remove the capital gains tax ‘uplift’ on death where a full spouse exemption applies, would have potentially far-reaching effects requiring much reviewing of wills and variations.

In the meantime, consider keeping the will as flexible as possible. Give careful attention to the choice of executors and whether there is a place for an independent professional to weigh up the increasingly complex options within the wishes regarding beneficiaries left by the deceased.

Use of the nil rate band and transferable nil rate band: Consider the use of the nil rate band and transferable nil rate band (where unused by a deceased spouse), e.g. by a nil rate band discretionary trust.

If any thresholds have not been fully used when the first person in a marriage or civil partnership dies, the unused part can go to the surviving partner. However, it is crucial to remember that you can only transfer 100% of a nil rate band even if the individual has had more than one spouse or civil partner, so often a transferable nil rate band is a 'use it or lose it' situation. Nil rate band discretionary trusts are one of the main forms of planning open to spouses who don't qualify for residence nil rate bands, as they do not have descendants, own their home or have an estate over the £2 million threshold.

However, a major use of the discretionary trust is also now to take assets out of the potential second spouse's estate, to avoid the loss of the residence nil rate band by the estate going over that £2 million threshold, to preserve one or two residence nil rate bands (£175,000 or £350,000 in 2020/21). This is a potential inheritance tax saving of £70,000 or £140,000 justifying some extra work and cost. Any gift to a nil rate band discretionary trust should include both any transferable nil rate band and any agricultural property relief or business property relief at 100% (and at 50% up to the maximum tax free amount).

Use of the residence nil rate band and transferable residence nil rate band: The residence nil rate band and transferable residence nil rate band, carried forward from a late spouse, carry the same maximum of 100% relief, so again use it or lose it. The classic use of the residence nil rate band is an immediate post-death interest trust for children or others who 'closely inherit' for residence nil rate band purposes. Immediate post-death interest trusts have a great role to play in securing this new relief, with great flexibility behind an initial interest that qualifies and with flexible powers that the trustees can exercise in time, guided (ideally) by a comprehensive and up-to-date letter of wishes.

A key element of planning on the death of spouse 1 is to ensure that the right ownership will apply for the residence nil rate band claim when spouse 2 dies. As the residence nil rate band is claimable on both a personal interest and an immediate post-death interest in one property, it can be crucial to get that right on the first death.

Agricultural property relief and business property relief: Agricultural property relief and business property relief deliver the potential to 'use' any 100% relief; e.g. by including in a nil rate band discretionary trust to maximise the relief on the first spouse's death. This might be especially valuable if there were a change in the law affecting eligibility for 100% relief or if the business/farm might be sold before the second death.

This is an area significantly impacted by the OTS report. Its proposals for farms and businesses are potentially huge in effect and, while the details are beyond our scope here, the potential change in the 'trading threshold' from at least 50% to over 80% could threaten the 100% business property relief claims of many. Suffice to say that, along with the potential loss of capital gains tax uplift where there is a full inheritance tax relief, this changes the dynamics of many farms and business owners about succession planning. Children and others who might be brought into a business can be helped by the more nuanced balance of tax issues, as opposed to the major disincentive to lifetime gifting that had applied for many years.

In conclusion

Clients need to be made aware of options in wills, and potential variations in estates and trusts, with great opportunities for advisers to show they are adding value by illustrating benefits that could flow from an optimal arrangement. It may be a consumer market but each must choose the service and cost mix they want.

The new Law Society IHT Planning Handbook, edited by John Bunker and Anthony Nixon, written with 14 Irwin Mitchell colleagues, seeks to cover all the mainstream elements of effective inheritance tax planning to help professionals in advising clients.