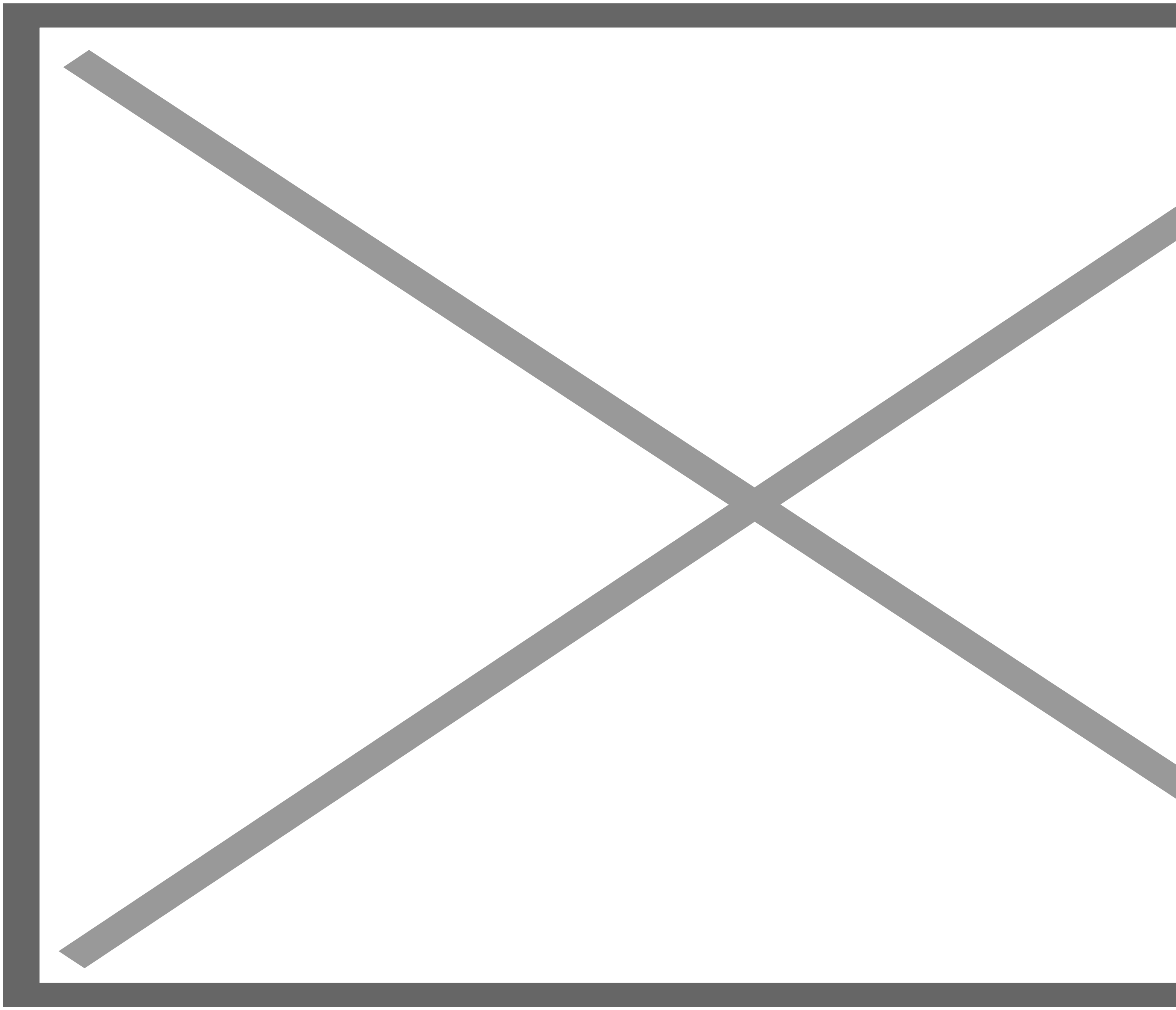
Many shapes and sizes

Indirect Tax



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Chris Beeston examines the inheritance tax consequences of lifetime giving

Key Points

What is the issue?

Inheritance tax thresholds remain static and more estates are becoming taxable estates.

What does it mean for me?

With more individuals having taxable estates, many tax advisers are well placed to try to ensure steps are taken early to mitigate this tax. Due to having at least annual contact we have opportunities to start conversations that do not always extend to other professionals.

What can I take away?

Early planning is essential and a mixture of the relatively small exemptions all combined can have a substantial effect over a number of years.

Inheritance tax planning comes in many shapes and sizes. Since the current nil rate band has not increased since 6 April 2009 and house prices continue their upward trend, more estates are coming within this tax. Lifetime planning is a vital tool in the tax planning of an estate. However, it can be tricky because one critical date is generally an unknown.

Exempt gifts

As always, some of the most effective planning tools are small, simple changes that can enhance the overall tax efficiency of the estate. There are various exemptions provided for gifts which, when used to their full potential consistently over many years, can add up to significant estate reductions.

First, there is the small gift exemption for any gift worth up to £250 made to one person in a single tax year. There is an unlimited number of these exemptions. For example, if you had 20 grandchildren every child could receive £250 each tax year and the whole £5,000 would be exempt from inheritance tax because there is no seven-year rule to apply.

Second, there is the annual limit. This is currently £3,000 and exempts the first £3,000 of any gift in one tax year from inheritance tax. If you did not fully use the previous tax year's allowance, you can carry forward the unused amount but only from the immediately preceding tax year. Any other tax year's unused amounts are wasted. Again, there is no seven-year rule to apply.

These exemption limits are extended if gifts are made in consideration of a marriage. The maximum exemption, as well as the usual annual limit, is £5,000 if the gift is a made by the parent, £2,500 for grandparents and £1,000 for any other person.

Third, a further type of exemption gift for inheritance tax purpose covers those that are made out of income, as opposed to capital.

These are exempt at the time they are made and there is no seven-year rule to apply. This exemption can be applied only to gifts made from your surplus income. Income for this purpose is all of your post tax income (including that from tax-free sources such as ISAs). From this you must deduct your normal expenditure. This is the expenditure needed to maintain your normal standard of living, even if this includes large expenses such as holidays. The only other criterion is that these gifts carry a degree of regularity. With modern banking this is often easily established by setting up a standing order with no end date.

Gifts out of income can be difficult to demonstrate and therefore difficult to claim the exemption, this is purely for practical reasons. The claim has to be made by the executors and often it is only the deceased who would have been able to provide sufficient detail to enable a claim. It is often helpful for the individual to complete the record-keeping themselves and store it for the executors to use when needed. HMRC's template on the back of form IHT403 is a good starting point.

If properly documented, gifts out of income can be very helpful with overall estate planning. They can even be used with other vehicles: for instance gifts out of income could be made to a trust, thereby reducing the estate immediately while retaining an element of control for the donor.

It is worth noting that some gifts, which in practice are often regular, do not fall within the gifts out of income provisions and therefore do not amount to a transfer at all for inheritance tax purposes. Payments made to assist with living costs between spouses, whether during marriage or on its dissolution, or payments made relating to the maintenance, education or training of a child are not subject to inheritance tax. This also applies when the payments are made relating to the provision of reasonable care for a dependent relative.

Last, a gift of any type to a registered charity is exempt from inheritance tax. This applies both in lifetime and on death. Whether or not cash or assets are given does not affect the inheritance tax treatment. In lifetime, however, other income and capital gains tax issues can be considered. A cash gift will extend the basic rate band, saving higher and additional rate income tax, whereas a gift of an asset will be exempt from capital gains tax (if chargeable) and will be a deduction from taxable income, saving all income tax on that amount.

It is worth noting that the tax rate on an estate is reduced to 36% if more than 10% is left to charity on death. Sometimes, it is beneficial to delay giving until death to obtain the reduction in tax over the remaining taxable estate.

Individual circumstances need to be assessed to decide the better route. Often when people have assets with heavily pregnant capital gains the gifting of this asset to charity, as opposed to cash, can be a tax-efficient way to diversify assets while being benevolent.

Non-exempt gifts

Any gifts that do not qualify for exemption to an individual are potentially exempt transfers (PETs). The value of the gift, less any remaining annual exemption and any business or agricultural property relief, starts on its seven-year journey to inheritance tax exclusion.

There is no tax to pay on the date of the gift. Inheritance tax will be payable only if the donor does not survive seven years from the date of the gift. If the donor survives between three and seven years the gift will be chargeable but taper relief will be available to reduce any tax charge, should there be one.

Lifetime transfers are taxed first in the inheritance tax computation so any available nil rate band is allocated to these gifts first. Any excess of the value of the gift, as calculated when it was made, is chargeable to inheritance tax. The tax itself is payable by the donee unless otherwise specified in the deceased's will.

Trusts

Trusts can carry a degree of mystery but they do carry with them significant benefits. The donor can release assets from their estate and still retain an element of control for up to 125 years in some cases or release benefits to beneficiaries over a long period as opposed to all at once. Since 22 March 2006 most lifetime transfers to trusts are chargeable transfers and are taxed differently from the PETs discussed above.

The notable exceptions are trusts set up for disabled persons and trusts self-settled when the individual is terminally ill. These transfers are either a PET, as in the case of a trust for a disabled person, or not a transfer for inheritance tax (because there is no loss to the estate), as is the case when the individual is terminally ill.

The transfer of any other type of trust in lifetime is a chargeable lifetime transfer (CLT). With a CLT there can be an immediate charge to inheritance tax when the gift is made.

Any value transferred to a trust (valued on the loss to estate principle) that is over the available nil rate band will be immediately taxable. The available nil rate band is calculated as the current amount (£325,000 in 2016-17) less any gross chargeable transfers made in the previous seven years. The gross chargeable transfers figure is any chargeable lifetime transfers made in the previous seven years plus the tax paid if paid by the donor.

The tax rate on this chargeable value depends on whether the trustees will pay the tax due from the funds they have received or whether the donor (settlor) will have to pay the tax arising as well as the funds transferred to the trust. If the trustees pay the tax from the funds received the rate is 20% and if the donor pays it is 25%. The tax rate is higher purely because the donor has gifted both the funds into trust and the tax itself.

If the donor dies within seven years the transfers will be taxed again in the same way as the PETs and also at 40%. Any tax previously paid will be deducted from the tax due but no repayment will be made.

An important point to note with lifetime transfers in trusts since 2006 is that most now fall within the inheritance tax relevant property regime. Therefore they are subject to inheritance tax charges when assets leave the trust and periodic tax charges every ten years. The charges themselves are usually small but the process of compliance can be costly and complicated.

Conclusion

Inheritance tax planning has no fixed form and can be highly emotive, involving numerous family members. But a mixed approach of exempt giving and well-planned lifetime giving can significantly mitigate a tax whose overall tax yield is ever increasing, regardless of the size of the estate.