

INHERITANCE TAX PLANNING

APRIL 2024

Inheritance Tax (IHT) is often regarded as the easiest tax to mitigate. However, care must be taken over the “**gift with reservation**” rules, and the **income tax on pre-owned assets**. This can make IHT difficult to completely avoid for items like the main family home, even with the recent introduction of the Residence Nil Rate Band.

In addition, there are several valuable reliefs available on gifts made in your lifetime, some of which are easily overlooked. Careful planning, with expert advice where appropriate, can make a big difference to the amount of IHT due on your estate – and, therefore, how much your beneficiaries ultimately receive. This note looks in detail at the main areas of planning.

Where your IHT planning leads to the need for advice on issues such as wills, trusts or powers of attorney, you can access this seamlessly through our clarityLAW service.

IHT RELIEFS AND ALLOWANCES

Inheritance tax (IHT) is charged on the value of an **estate at death**, as well as on certain **lifetime gifts** and some **transfers into and out of trusts**.

The first £325,000 (frozen until 5 April 2028) of an individual's **estate on death** is exempted via the **nil rate band**, and thereafter IHT is **charged at 40%**. In addition, the **residence nil rate band** can increase the exempt amount by £175,000 (also frozen until 5 April 2028). The rate of IHT can be reduced to 36% if at least 10% of the estate (net of reliefs and the nil rate band) is given to charity.

The IHT rate on chargeable lifetime transfers (e.g. to most trusts) is 20%.

It is possible to reduce or eliminate liability to IHT by taking advantage of a number of reliefs and exemptions. The main ones are as follows:

Main IHT Reliefs and Exemptions	
Relief/Exemption	Details
Nil-Rate Band	No tax on first £325,000 of estate on death
Residence Nil-Rate Band	No tax on first £175,000 of main residence/proceeds thereof passed to a direct descendant. Band tapered by £1 for every £2 the estate exceeds £2m
Inter-Spouse Transfer	Complete exemption unless the recipient spouse is non-UK domiciled.
Potentially Exempt Transfer	Complete exemption on most outright gifts if donor survives for 7 years from date of gift.

IHT RELIEFS AND ALLOWANCES

Main IHT Reliefs and Exemptions	
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Taper Relief	Tax due on gifts made within 7 years of death reduced by: Years 3-4: 20% Years 4-5: 40% Years 5-6: 60% Years 6-7: 80%
Normal Expenditure Out of Income	Complete exemption for genuine gifts out of surplus income, where a pattern of such gifts is established.
Business Property Relief	Up to 100% relief on business assets which have been owned for at least 2 years (includes assets used in a trade and certain shareholdings).
Agricultural Property Relief	Up to 100% relief on agricultural assets which have been owned for at least 2 years (including land and possibly a farmhouse).
Annual Gifts Exemption	Up to £3,000 per annum, per donor. Unused exemption for previous year only can be carried forward.
Small Gifts	Up to £250 to each individual in each tax year. Cannot be combined with other exemptions.
Gifts on Marriage/ Civil Partnership	Each parent can give £5,000; each grandparent can give £2,500; others can give £1,000.
Gifts to Charities, Political Parties and for the National Benefit	Complete exemption for qualifying gifts.

IHT RELIEFS AND ALLOWANCES

NIL-RATE BAND

This is the amount that you can leave to your beneficiaries on your death, with no IHT charge being made. It is currently £325,000 (frozen until 5 April 2028). It is reduced by any gifts or other transfers of assets that you have made in the 7 years prior to your death.

Please note that any unused nil-rate band on the death of the first spouse can be transferred to the surviving spouse for future use (in addition to their own nil-rate band).

RESIDENCE NIL-RATE BAND

An additional residence nil-rate band of £175,000 (also frozen until 5 April 2028) is available for property which is, or has been, a main residence. The property must be passed to direct descendants.

The residence nil-rate band is also available when an individual downsizes or ceases to own a home on or after 8 July 2015, and the assets or an equivalent value are left to direct descendants.

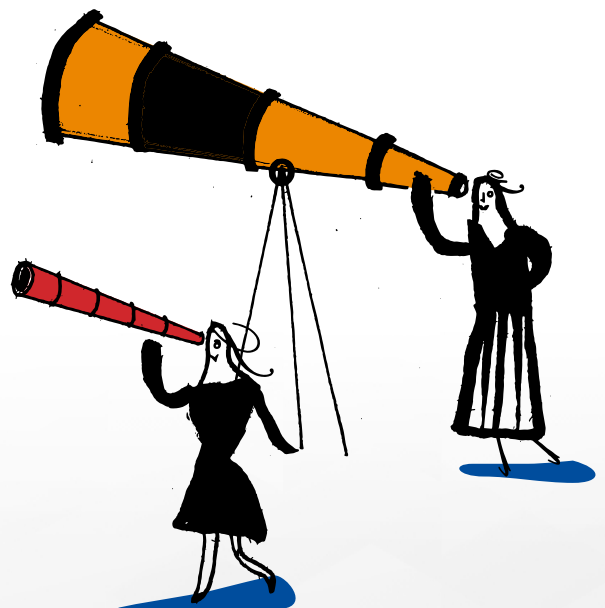
Any unused band on death can be passed to a surviving spouse as for the standard nil-rate band. The band is tapered for estates over £2 million, by £1 for every £2 in excess of this figure.

TRANSFERS BETWEEN SPOUSES

Transfers between spouses, whether during life or on death, are exempt unless the transferor spouse is UK domiciled and the transferee spouse is not. In the latter case, the exemption is limited to the level of the nil-rate band, although the non-domiciled spouse can elect to be treated as UK domiciled before or within 2 years of death, bringing their worldwide assets into the UK IHT net (2024/25 only, the domicile regime is due to be replaced by a residence-based regime from April 2025).

Elections will be irrevocable whilst the individual remains UK resident, but can be revoked once the individual has been non-UK resident for more than four consecutive tax years.

The exemption also applies to where one of the spouses is given an interest in possession under a trust, possibly created by a will.



IHT RELIEFS AND ALLOWANCES

POTENTIALLY EXEMPT TRANSFER (PET)

If you make an outright gift to another individual, and survive for 7 years there will be no tax to pay on your death. If you survive for at least 3 years but less than 7 then the tax due on your death is reduced by taper relief. However, this relief is often more illusory than real. The problem is that if you survive for, say, 4 years and then die, the PET is set against your nil rate band first before the balance of your estate.

Example: an individual decides to make a gift of £325,000, but dies just over 5 years later.

You might expect the IHT to be reduced by 60% (a saving of £78,000 i.e. $£325,000 \times 40\% \times 60\%$ taper relief).

In fact, the position is that the £325,000 gift is set against the Nil Rate Band and the balance of the estate, after any Residence Nil Rate Band is applied, is taxed at 40%. **The PET has resulted in no tax saving whatsoever.**

Putting it another way, the taper is applied to the tax payable. If the tax payable is nil (as is the case in the example above because the amount falls within the nil rate band), then the taper effect will also be nil.

NORMAL EXPENDITURE OUT OF INCOME

A gift will be exempt if:

- It was clearly made out of income (not capital)
- It was part of the transferor's normal pattern of expenditure (generally established by making a pattern of similar gifts for at least 2 years)
- The transferor is left with enough income to maintain their standard of living

ANNUAL GIFTS ALLOWANCE

This is £3,000 p.a. and any allowance not used in the previous year can be carried forward (for one year only). The allowance is per individual, so a couple could make gifts of £12,000 in the first year and £6,000 per annum thereafter.

GIFTS ON MARRIAGE

Certain gifts in consideration of marriage are exempt including £5,000 per parent to their child, and between £1,000 - £2,500 for remoter relatives and friends.



DOMICILE

(2024/25 ONLY)

The concept of **domicile** is, currently, very important in IHT (but is due to be superseded by a residence-based regime from April 2025, details currently under consultation). Broadly speaking an individual acquires a “**domicile of origin**” on birth (generally the domicile of their father if their parents were married, or mother if not). They will keep this domicile forever unless the facts suggest that a “**domicile of choice**” has replaced it. A domicile of choice might be assumed for example if someone moved away from the UK, severed all permanent links with the UK and settled permanently in a new country with no intention of returning to the UK other than for occasional visits.

The concept of **deemed domicile** also applies. Those who have been resident in the UK for **more than 15 out of the past 20 tax years** will be treated as deemed UK domiciled for all tax purposes. This will mean that they will no longer be able to use the remittance basis and they will be deemed UK domiciled for inheritance tax purposes. In addition, those who had a domicile in the UK at the date of their birth will revert to having a UK domicile for tax purposes whenever they are resident in the UK, even if under general law they have acquired a domicile in another country.

Note that an individual from France, Italy, India or Pakistan may be covered by a long-standing double taxation treaty, and not treated as deemed UK domicile.

For UK domiciled individuals, IHT is charged on death on worldwide assets, wherever these are located.

For a non-UK domiciled individual IHT is only charged on assets physically located in the UK, such as UK property.

See our note on Residence and Domicile for more information.

IHT PLANNING

IHT is often regarded as the easiest tax to avoid paying. Quite simply if you give everything away more than 7 years before you die then your executors will probably have no IHT to pay. However, **for gifts to be effective for IHT purposes, you are not able to retain any benefit**; i.e. they must be outright. Therefore, giving away everything is simply not practical, or desirable, for most people.

GIFTS WITH RESERVATION

Herein lies the problem most normally encountered with IHT planning – how to give away an asset, and thus save the beneficiaries 40% tax, but still continue to gain benefit from it? HMRC legislation dictates that a transfer of legal title to an asset will not be effective for IHT purposes if the person making the gift (the donor) retains a benefit. Therefore, the questions often asked are:

- How do I give away my house and continue to live in it? This is very difficult, but has historically not been impossible. However, the introduction of an income tax charge on pre-owned assets may render much planning ineffective (see below).
- How do I give away my share portfolio or cash and continue to receive an income – this is even more difficult although there are a number of insurance company plans that claim to provide a solution (see below).

IHT PLANNING

FUNDING FOR IHT

Many people take the view that IHT planning is not practical and instead they take out an insurance policy (normally a whole of life plan), which will one day, on their death, pay out a sum to settle any IHT with. The policy benefits are normally written under trust and therefore will be free from IHT.

Please note that this does not in itself reduce the IHT payable, it simply provides for an additional sum to pay the IHT and so increase the net payment to the beneficiaries – it is therefore necessary to consider whether your beneficiaries require such additional protection. Please see the Research Note in the Protection section for further details.

IHT PLANNING AND THE HOME

For many people their property may well be their most valuable asset. The IHT nil-rate band is only £325,000, or £500,000 including the residence nil-rate band. Even where the full nil rate band is transferred between spouses, the total resulting nil rate band may only be the equivalent of around £1,000,000. With the rapid house price inflation experienced in the last few years, many homes in the UK are worth more than this. There is therefore often a need for considerable IHT planning surrounding the family home.

The following are some of the main ideas:

Gift and Rental

The property is gifted to grown up children. The parent continues to live in the property but pays a full market rent to his/her children.

Equity Release

The parent(s) borrow against the property with the interest rolled up and deducted from the value of the property on the last parent's death. The lump sum borrowed is gifted to children.

Insurance Schemes

There are a variety of “off the shelf” IHT planning schemes on the market. An analysis of these schemes is outside of the scope of this section, not least due to the number of schemes available and the complexity. What these “have your cake and eat it” schemes all attempt to achieve is a gift of assets with some continuing right to income or capital after the gift, without bringing into play the gift with reservation or pre-owned assets tax rules.

Tenancy

It should be noted that any property owned by a husband and wife as “joint tenants” passes automatically to the surviving spouse and is not subject to the terms of the will. In many cases a home will be owned under a joint tenancy. It is possible to create a “tenancy in common” arrangement instead and under these circumstances the share of the deceased spouse passes under the terms of their will. This type of arrangement is often used where IHT planning is anticipated with the family home.

IHT PLANNING

FIND OUT MORE

IHT PLANNING AND THE HOME

Foreign Property

Foreign property and investments may be made and retained by an individual in their own name. However, direct ownership of those foreign assets can present disadvantages such as the obligation to comply with local administrative procedures and succession laws on death, and the possibility of facing wealth or inheritance taxes imposed by the country in which the asset is situated.

Consideration should therefore be given to ownership through other vehicles including companies and trusts.

Some countries, notably France and Spain, are civil law jurisdictions and the concept of a personal representative is alien. Furthermore, property located in these jurisdictions may be governed by “forced heirship” rules with a certain percentage passing to defined beneficiaries irrespective of the wishes of the deceased. For these reasons many UK individuals who own French holiday homes do so through a “societe civile immobiliere” (SCI). This should enable them to avoid the French “forced heirship” rules and administration problems by leaving their shares by UK will. However, this is an area fraught with difficulty on both sides of the channel and expert advice is essential.

Back in 2007, the then-Chancellor announced that HMRC would no longer seek to impose a benefit in kind tax charge where the sole activity of the company is to hold the property for occupation or letting. However, care should still be taken in this area, for example to ensure that the company is not treated as UK resident.

If you have any questions about our investment methodology, or would like some financial planning or investment advice, the clarity team are here to help.

Please contact your usual clarity adviser, or get in touch using the details below:

Tel: **+44 800 368 7511**

Email: enquiries@clarityglobal.com

Address: **1 Crown Square, Woking, Surrey GU21 6HR**

Web: clarityglobal.com

Twitter: twitter.com/clarityglobal

Instagram: instagram.com/clarity_global

LinkedIn: linkedin.com/company/clarity_7



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