be inspired.

Introduction

Inheritance tax (IHT) is not unique to the United Kingdom. Many countries around the world impose their own form of IHT with their own rules but the UK's rules are particularly onerous. IHT is an inherently (no pun intended) unfair tax. To tax money when passing it to beneficiaries, which has already been subject to several different taxes, is simply a method of obtaining increased revenue. However, for most people it is possible to either avoid IHT totally or to mitigate it.

Warning:

This report was written based on the legislation as it stands at the time of writing and our understanding of it. It obviously cannot allow for any future changes that the Chancellor may make. This is for discussion purposes only and **this report is not intended as IHT advice, investment advice or specific risk strategies or advice.**

Brief Description:

Once you have wills that take IHT into consideration and you are making full use of your allowances (wherever possible), there are two extremes you can pursue. The first is to simply do nothing more and allow your beneficiaries to pay the remaining tax liability (effectively) out of the estate. This is the nil cost solution (as far as the current holder of the estate is concerned), but does nothing to mitigate a potentially large tax burden. The second extreme is to take advantage of the PET rules and to give away your entire estate (except the nil rate band) to your beneficiaries now. There are clearly drawbacks to both of these alternatives. Either the taxman receives a large proportion of your estate (in addition to all the tax you have paid during your lifetime whilst building up your wealth), or you are left with potentially insufficient assets to ensure that your lifestyle can be maintained.

In many cases, one of the biggest assets, and therefore biggest problems, is the family home. This does not always allow you to consider giving away all assets above the nil rate band (as the property may itself be worth more than, or a large proportion of, the two sets of this band). You cannot gift assets that you retain any benefit from (gifts with reservation) – this is not effective for IHT planning. We consider the current legal framework not contentious with the Capital Taxes Office.

There are obviously very different results in terms of your beneficiaries depending on the two extremes outlined. If you do nothing, your beneficiaries need to pay the IHT bill before they can gain access to your assets. In many cases, this requires bridging finance from a friendly bank.

However, if you decided to gift all your assets (above the nil rate band) direct to your beneficiaries now, it may result in undesirable consequences. Your beneficiaries may change their lifestyles in a way that you are not happy with, they may spend the funds on something that you would prefer them not to buy, invest the funds where you would prefer them not to invest, or lose considerable amounts of your gift if they become bankrupt or divorced. On the other side of this argument, you can see your beneficiaries enjoying part of their inheritance during your lifetime and it could make their lives considerably easier allowing them to reduce or eliminate their debts.

It is important that your final decision takes into account how you and your beneficiaries are affected, as well as how much tax can be saved. Below is an example outline report; full reports are written by skilled technicians and provide you with the options and considerations that you require to make a decision. In all our dedicated reports (often 40 pages long), we use our own software, calculations and knowledge for each individual. We do not buy in outside agencies or pre-written reports.

Prepared by **Aisa**Professional

Advanced
Independent
Specialist
Advice

This report was prepared by James Pearcy- Caldwell & John Reid

AisaProfessional © Aisa Direct Ltd 2002-09

AisaProfessional is a trading style of Aisa Direct Ltd who is an independent financial adviser authorised and regulated by the Financial Services Authority. Registered in England: 3621676

Example Case Study Answer:

Inheritance Tax Report

Introduction

Peter and Mary Parker have recently inherited money from Mary's mother, Katy. Katy recently died but her husband died several years ago. Peter and Mary have a solid marriage and 3 children. Our objective is to ensure the least tax is paid on the inheritance from Katy's estate, whilst considering any future liability due upon the inheritance by Peter and Mary's three children.

We shall do this by:

- considering the position of Katy's estate just prior to her death, allowing for the previous inheritance when Donald died.
- reviewing the current position and any changes we can make, allowing for trusts, capital access, income requirements and the children.
- setting out recommendations for trusts and the investments required.

Overview and Assumptions

- Katy died on or after 6th April 2009, giving her a nil rate band of £325,000.
- When Donald died in March 2003 he left £100,000 to Mary and £1000 to each grandchild totaling £3,000.
- We assume he had not been married before.
- Political promises and party pledges, made before Treasury debt and public finance issues, to increase the IHT threshold cannot be discounted, but we base our advice on current legislation.

There is some argument as to whether Donald's gifts at Christmas qualify as a "Normal expenditure out of income". Any discussion or agreement with HMRC at time of Probate is not explained.

However, it is pertinent. In combining the gifts at Christmas, along with further gifts on death would mean he transferred £103,000 from his estate inheritance tax allowance at the time. Whereas if the aforementioned Christmas gifts qualified as "Normal expenditure out of income" then there would be an argument that only £100,000 were transferred and also, the previous year's allowance may also be available.

- Assumption 1 - He hasn't utilised his £3,000 annual allowance, allowing it to be used for the year he died and the previous tax year. This means that his non-exempt estate transfer would have been £97,000 of the then nil rate band (NRB) of £250,000.
- Assumption 2 - He has utilised his £3,000 annual allowance, meaning it could not be used for the year he died, nor the previous year. This means that his non-exempt estate would have been £103,000 of the NRB of £250,000.

Katy's Estate just prior to death

Assumption1 (as above) - means that Donald used up 38.8% of his NRB. Katy therefore has an extra 61.2% of the current NRB that can be used to reduce IHT, making an increase of £198,900 giving a total NRB of £523,900.

The house was valued at £725,000 so the original IHT would be based on this. The estate of £800,000 minus the NRBs of £523,900 leaves a net estate of £276,100, which would mean a payment of £110,440 IHT (40%)

Example Case Study Answer:

Inheritance Tax Report

Assumption2 (as above) - means that Donald used up 41.2% of his NRB. Katy therefore has an extra 58.8% of the current NRB that can be used to reduce IHT, making an increase of £191,100 giving a total NRB of £516,100.

The house was valued at £725,000 so the original IHT would be based on this. The estate of £800,000 minus the NRBs of £516,100 leaves a net estate of £283,900, which would mean a payment of £113,560 IHT (40%)

The current IHT calculation

We would very much argue for Assumption 1 with HMRC if the case was not determined, and from this point forward we will assume that we have won that discussion after evidence of the regular payments from income each year to the children.

Although the tax has to be paid prior to probate any excess tax would be reclaimed by use of Form IHT38 from HMRC. In this case the house was sold at £640,000 net which would mean a claim for £34,000 excess tax.

I therefore estimate under Assumption 1 that the IHT payment to HMRC will be £110,440 reducing to £76,400.

Net estate transferrable

The net estate value after tax and costs would be under Assumption 1:

Value received for house	*£*	*640,000*
Cash	*£*	*75,000*
Solicitors costs (assumed 1%)	*£*	*7,150*
HMRC tax bill	*£*	*76,400*

This would ultimately leave an amount to be transferred of £631,450

Of this £30,000 has been gifted to the grandchildren leaving currently £601,450 to be available for Mary and Peter.

Current Situation

We are aiming to minimise the IHT the children have to pay on the death (especially early) of either Mary and/or Peter. The mortgage of £255,000 is currently affordable as long as Mary is employed, she is however concerned that her job might not be secure, so she can't afford to give all the money to the children at the moment.

We should consider Mary and Peter's position as if the IHT transfer has yet to take place. What was their position prior to Katy dying:

- They would have no IHT to pay on their own estate.
- Their pensions should be in trust and outside their estates (I would of course check this).
- The net value of the house after the mortgage is paid off is £195,000 and
- the value of bank deposits and investments are currently £30,000.

This makes a total of £225,000 which is currently absorbed by one NRB.

Example Case Study Answer:

Inheritance Tax Report

Given Mary's concerns about her job she may want to pay off the mortgage as soon as possible, however as the job is still secure at the moment it would probably be better to keep the mortgage and have the money available to repay the mortgage if, as against when, her job fears are realised.

The ideal situation would be for the money to be invested in a way that reduces IHT whilst still giving Mary and Peter access to it if necessary.

Possible Solution

As Katy has died very recently it would be possible for a Deed of Family Arrangement to be executed placing her estate into discretionary trusts. This would not reduce the IHT on Katy's estate, but could have a spectacular effect on the children's inheritance on the death of Mary and Peter. The £10,000 legacies to the children could be included in this or simply kept out of the equation, perhaps held on bare trust for the girls until their 18th birthday.

The beneficiaries of the discretionary trusts would be Mary, Peter and the 3 children. As stated above this would have no immediate effect, it would neither reduce Katy's IHT bill, nor would it affect Mary's IHT profile as she would not be deemed to be making a Chargeable Lifetime Transfer (CLT) or a Potentially Exempt Transfer (PET). The trust would not fall foul of the Gift With Reservation (GWR) rules.

Unlike under "bare" or "interest in possession" trusts the discretionary trust does not have beneficiaries who have an absolute right to benefits. This means that the parents can keep the money out of the hands of the children until they consider them old enough to handle it.

I would suggest that three separate trusts are set up, each a week apart (subject to the cost-effectiveness of this!). This could allow the trustees easier administration, especially if they were to earmark each trust to be for a particular daughter which would further justify the position of having set up different trusts which would lead to less inquisitiveness from HMRC in future.

This set up would be much more flexible than setting up one single trust. Trust A would be for daughter A, excluding the other 2 daughters and so forth.

If Daughter A for example needed a deposit to buy a house, the trustees could provide it from Trust A, without disturbing the benefits of the other 2 daughters. If, later on, each individual daughter developed her own specific attitude to risk and wanted to have specific investments, having her own "bundle of money" would certainly make things more straightforward for the trustees. It **could** also have the effect of reducing the 10 year recurring tax and exit penalties as each trust has its own nil rate band under current legislation (setting up the trusts on different weeks with the different beneficiaries gives them a better chance of being acceptable to HMRC.).

The remainder estate £601,450 could be placed into 3 discretionary trusts, thus saving the family from a large future IHT bill.

Alternatively, if we assume the money, excluding the £30,000 of legacies were simply placed into Mary's and Peter's joint estate; the estate would amount to £826,450, which allowing joint use of two nil rate bands would equate to £650,000, and would leave £176,450 taxable and would result in potential inheritance tax of £70,580. There are further issues here:

1. Use of trusts avoids future problems in the event of divorce;
2. Use of trusts would assist in not requiring such complex future "will" arrangements and would avoid probate in the future access of money by the children and their guardians.

We would set-up trusts in no one's estate for IHT purposes, with whom selective parents and children would have access to, as and when, needed. If Mary does lose her job and feels the need to pay the mortgage off, the money could be paid from the trusts.

Example Case Study Answer:

Inheritance Tax Report

The flexibility in this arrangement and method of doing this would be decided at the time, it could either be by a capital advance or by a loan, depending on the legislation and the clients' then circumstances. The loan, interest free repaid on death or demand, would have the effect of forming a debt on the estate potentially reducing any IHT which might then be payable. Although Mary's net income after pension contribution is currently £5,370 more than the family expenditure (allowing Peter to keep his £5,000 pa!) the family may need an income boost at a later stage, the trust will allow for this, although care will need to be taken to ensure the payouts are not deemed to be regular, and further advice should be sought at that future time.

In order to defer income and capital gains tax within the trust as far as possible I would recommend the trustees invest via an offshore bond for the two younger children (not withstanding any possible surrender penalties of money required early). Therefore, a trust wrapper may be utilised which further cash elements are then invested in as part of the overall portfolio. This gives the advantage of CGT free and income tax reduced (withholding tax) growth. The fact there is no immediate need for the money increases my confidence that the beneficial tax treatment will more than cover any extra charges incurred.

The bonds for the two younger children would be clustered into as many policies as possible so that when withdrawals are needed from the trust proper tax planning could be carried out. It may be appropriate to make use of the 5% tax deferred facility or a whole policy or series of policies could be surrendered. Depending on the income tax profile of the beneficiary it might be more appropriate to assign the policy in specie to that beneficiary. An example of this would be assigning a policy to Peter who, at £5,000 pa would be a non-taxpayer. He couldn't avoid paying basic rate tax by using top slicing, but could certainly save the family from paying higher rate tax.

The bonds to be used would be a semi-personalised bond with open architecture. This means that the contract can't invest directly into equities, property etc, but can make use of collective investments. The most advanced of these contracts will allow investment into any authorised unit trusts, OEICS, investment trusts along with offering a plethora of deposit facilities for the cash portion of the portfolio.

For the eldest daughter, with only 4 years potentially until she may realise assets it would be wiser to take a more discretionary fund approach. Whilst taxes may not be avoided as efficiently, this benefit would be outweighed by the flexibility to gain access to larger amounts in shorter periods of time.

Attitude to Risk

In everything that we do, our attitude to the risks that we take in our lives is paramount. It would therefore be important to assess their overall attitude to risk and their attitude to risk for individual investments. It is these two separate assessments, along with a discussion about the consequences of achieving and not achieving their goals that we would use to determine the asset allocation in the investment portfolios.

We have been told to assume they are happy with around 50% of their money invested in equities and an appropriate asset allocation, allowing for the length of time for each child to age 18 would alter the recommendation for each trust. The average recommendation would be as follows:-

Area	**Percentage**
UK Fixed Interest	37%
Property	15%
UK Equity	12%
USA & Canada	9%

Europe excluding UK	9%
Japan	5%
Global Equities	5%
Far East excluding Japan	4%
Emerging Markets	4%
Total	**100%**

This places 48% of the investment into equities; the ABI definition of a Cautious Managed Fund has up to 60% invested in equities.

Monitoring and review

With such a complex arrangement it will take several weeks for the advice to be actioned and follow-ups maintained weekly. Thereafter a regular bi-annual review of investments should be set up for the first 5 years, with a trust review necessary at 9 years.

Conclusion

We have saved tax on Katie's death by utilising Donald's unused allowances. We have utilised trust planning to save further future tax on the estate of Peter and Mary, whilst providing flexibility to either, invest the whole inheritance into separate trusts, or to pay off their mortgage as required.

We have discussed the advantages of trusts in terms of flexibility and control both in event of death and divorce.

We have set up an appropriate vehicle for each trust to invest in depending on each child's age.

We accept Peter and Mary may feel happier about keeping a proportion of cash within the portfolio, say £255,000, to cover the mortgage with the balance invested as above.

Other Areas of Importance

1) I accept the inheritance may pay off the mortgage completely making the future safe irrespective of death of either party.
2) Alternatively, the mortgage is 'interest only', we should explore ways of paying it off, possibly switching to a 'repayment' basis.
3) Mary and Peter should consider additional protection, at least enough to pay off the mortgage in the event of death. Due to high cost we may recommend life only for the whole mortgage, and reduced critical illness cover.
4) Following on, this cover becomes critical in the event of Mary stopping work and losing cover, or indeed if she were to die. There is insufficient cover for Peter to remain in the house without utilising the investments, although Peter also required cover to allow Mary to work after his death.
5) If they elected to pay off the mortgage increasing the likelihood of future IHT on their estate they could consider a Joint Life 2nd Death whole of life policy. At their ages this should cost a small proportion pa of the money saved on mortgage payments.

2499words