

A Guide to Inheritance Tax Planning

How does Inheritance tax work?

Inheritance tax (IHT) is a tax which is paid on the things of value you leave behind when you die. This is called your estate. A person's estate includes everything owned in their name; the share of anything owned jointly; gifts from which they keep back some benefit, such as a home given to a son or daughter but still lived in by the parent; assets held in some trusts from which they receive an income.

Against this total value is set everything that the deceased person owed, such as, any outstanding mortgages or loans, unpaid bills, and costs incurred during their lifetime for which bills have not been received, as well as funeral expenses.

Many people think that IHT only concerns the very wealthy. Nothing could be further from the truth. Property prices are such that the value of your property alone can [easily exceed the tax threshold](#).

The tax threshold (or nil rate band)

You only have to begin paying IHT at a certain point called the threshold or nil rate band. In the tax year 2010/11, the threshold or nil rate band is £325,000 for individuals and £650,000 for couples. If the value of your estate, including your home and certain gifts made in the previous seven years, exceed the threshold, tax will be due on the balance at 40%. However, an estate passing to your spouse/civil partner or charities will pass completely free of inheritance tax.

Married couples and registered civil partners are also allowed to pass assets from one spouse or civil partner to the other during their lifetime or when they die without having to pay Inheritance Tax - no matter how much they pass on - as long as the person receiving the assets has their permanent home in the UK. This is known as spouse or civil partner exemption.

If someone leaves everything they own to their surviving spouse or civil partner in this way, it's not only exempt from Inheritance Tax but it also means they haven't used any of their own Inheritance Tax threshold or nil rate band. It is therefore available to increase the Inheritance Tax nil rate band of the second spouse or civil partner when they die - even if the second spouse has re-married. Their estate can be worth up to £650,000 in 2010-11 before they owe Inheritance Tax.

When the tax must be paid

In most cases, IHT must be paid within six months from the end of the month in which the death occurs. If not, interest is charged on the unpaid amount. Tax on some assets, including land and buildings, can be deferred and paid in instalments over 10 years. However if the asset is sold before all the instalments have been paid the

outstanding amount must be paid. The IHT threshold in force at the time of death is used to calculate how much tax should be paid.

What actions can be taken to reduce this tax?

1. Write a will

A will makes your wishes concrete and clarifies who should get what. It will stop any assets being divided under the rules of intestacy, where even spouses are not guaranteed to inherit everything. It can also be the first step to reducing an inheritance tax bill. Many married couples draft wills that pay part of their wealth into a trust on death. The surviving spouse can benefit from the legacy, but so can others such as children and grandchildren. The aim is to give the option for both husband and wife to use their full inheritance tax allowance on death.

2. Gifts

Any amount of money given away outright to an individual is not counted for tax if the person making the gift survives for seven years. These gifts are called 'potentially exempt transfers' and are useful for tax planning.

Some cash gifts are exempt from tax regardless of the seven-year rule. They include:

- wedding gifts of up to £5,000 to each of your children;
- wedding gifts of £2,500 to each grandchild, and wedding gifts of £1,000 to anyone else;
- other gifts of up to £3,000 a year (plus any unused balance of £3,000 from the previous tax year);
- gifts of up to £250 each to any number of people each year;
- gifts to charities, the National Trust, national museums, the main political parties and most registered housing associations.
- Regular gifts from after-tax income, such as a monthly payment to a family member, are also exempt as long as the giver still has sufficient income to maintain their standard of living.
- Any gifts between husbands and wives are exempt from IHT whether they were made while they were both still living or left to the surviving spouse on the death of the first. Tax will be due eventually when the surviving spouse dies if the value of their estate is more than the combined tax threshold, currently £650,000.

3. Review Asset ownership

It can make IHT planning sense for a husband and wife or civil partners to divide their assets between them so to 'equalise' at least in part their estate. They can then ensure that they each take advantage of their full nil rate band allowance of £325,000.

3. Minimise your estate

It is sometimes possible to rearrange life and pension policies so certain payments on death fall outside your estate. This is often done by transferring to a trust. If your employer pays a death benefit, a nomination form can ensure that any money goes directly to the person you choose and not into your estate.

4. Consider marriage

Anything you pass on to a spouse is free of inheritance tax. The same concession applies to same-sex couples who register under civil partnership laws.

However, legacies between unmarried couples are not tax free - a serious problem when a couple jointly own their home. This can lead to people having to pay an IHT bill just to continue living in their home.

5. Using Trusts

A Trust is a way of making a gift whilst retaining some control over it. Most people are keen to remove assets from their estate but are reluctant to hand over large sums to their heirs unless they have adequate protection. A trust is an obligation binding a person called a trustee to deal with 'property' (assets) in a particular way for the benefit of one or more 'beneficiaries.'

- Trust property: this can include money, investments, land or buildings and other assets.
- The cash and investments held in the trust are called the 'capital' or 'fund' of the trust. This capital may produce income, such as interest or dividends. Land and buildings may produce rental income.
- The 'settlor' is the person who creates the trust and puts property into it at the start or later on. The settlor states in the trust deed how the trust's property and income should be used.
- The trustees are the 'legal owners' of the trust property and must deal with it in the way set out in the trust deed.
- Beneficiaries are the individual/s who benefit from the property held in the trust. These are usually named individuals or members of the settlor's family. Different beneficiaries can benefit from the trust in different ways, i.e. from the income only, the capital only, or both.

6. Reliefs

There are two main forms of relief from IHT. The first is Agricultural Property Relief, relating to gifts of agricultural property and the second is Business Property Relief relating to gifts of qualifying business assets and interests.

