



# A Client's Guide on Inheritance Tax (IHT)

Updated after the 2011 Budget



***Please note:-***

*Thursfields make your Will to suit your own requirements so each and every Will is prepared individually. This Client Guide is only an outline of the points you need to consider before you call to see us to discuss your wishes. So before you take any action based on this Client Guide please seek our specific advice.*

*Where any point is not covered in this Client Guide then please ask our further advice as for reasons of space we cannot set out in this Client Guide every matter you may need to consider.*

*Please remember that legal, and taxation, matters are complex and you should not take any action, or inaction, just from reading one of Thursfields' Client Guides. You should discuss this with us first.*

*This Client Guide only applies to Wills made in England and/or Wales and reflects Thursfields understanding of the law (in England and/or Wales) as at the date of this edition of this Client Guide.*

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## INHERITANCE TAX (IHT)

### *How inheritance tax operates - a simple review*

- IHT is charged on everything that you own.
- Transfers between spouses are exempt.
- Gifts to charities and also political parties are also exempt.
- If you have an interest in a Trust when you die then the value of the Trust Assets when you die may have to be added to your other assets in order to work out the total IHT payable.
- Otherwise the whole of an estate on death, usually plus gifts made during the preceding seven years are taxable
- The first **£325,000** (which is the **Nil Rate Band**) of your estate on your death is **not** liable to IHT. The balance of your estate above **£325,000** is then taxable at **40%**. Each person has this **Nil Rate Band** (sometimes called the IHT Tax Threshold).
- A married couple, or couple in a civil partnership, each have a Nil Rate Band (each) of **£325,000**.
- So, a married couple, or couple in a civil partnership, when you add together (for IHT planning purposes) their own Nil Rate Band will, together, then total **£650,000** (that is to say two times £325,000).
- *Please note that :-*
  - ◆ the Budgets from 1997 to 2005 did not make any major changes to IHT. The HM Revenue & Customs (HMRC) has increasingly led the attack on what they consider to be IHT avoidance schemes.
  - ◆ the 2006 Budget through Budget Note 25 which became the Finance Act 2006 proposed many IHT changes in the area of trusts.
  - ◆ the Pre Budget Report 2007 proposed a “new” IHT **Spousal Nil Rate Band Transfer** system (see Section 3 below). These changes were confirmed in the Finance Act 2008.

### *Important Dates for IHT and Capital Taxation*

Capital Taxes have seen several major changes over the years. The most important of these are as follows.

1. 1694 = Probate Duty was introduced
2. 1780 = Legacy Duty
3. 1853 = Succession Duty
4. 2<sup>nd</sup> August 1894 = **Estate Duty** introduced
5. 6<sup>th</sup> April 1965 = **Capital Gains Tax** (CGT) was introduced.
6. 12<sup>th</sup> March 1975 = **Capital Transfer Tax** (CTT) was introduced (and Estate Duty was abolished though there are a one or two transitional reliefs still applying). This was also a tougher lifetime gift tax. It introduced the concepts of **Potential Exempt Transfers** and **Chargeable Transfers**. The then new capital taxation regime for Discretionary Trusts (a 10 Yearly Anniversary CTT charge and an Exit CTT charge) began. However Gifts with Reservation of Benefit were abolished.
7. 17<sup>th</sup> March 1986 = CTT became **Inheritance Tax** (IHT) (and CTT was abolished). This was in many ways CTT by another name. Gifts with Reservation of Benefit were re-introduced with IHT. The main difference to CTT was **Transfers of Value** (instead of Chargeable Transfers).
8. 10th March 1992 = The rates of IHT for Business Property Relief (BPR) and/or Agricultural Property Relief (APR) were increased from 50% to 100% and from 25% to 50% (see below).
9. 6<sup>th</sup> of April 2005 = The introduction of **Pre Owned Assets Tax** (POAT) which was in HMRC’s view a charge to Income Tax for those who were trying to reduce their IHT bills.
10. 22<sup>nd</sup> March 2006 = The date of the change in the IHT treatment for most existing and future trusts (except for Discretionary Trusts) introduced by the 2006 Budget.
11. 9<sup>th</sup> October 2007 = The date of the Pre Budget Report 2007 which introduced the **Spousal Nil Rate Band Transfer** system (which was confirmed by the Finance Act 2008 - see **Section 3** below).

### *The main IHT planning points are:-*

#### *1. Gifts to spouses*

A gift to your spouse is free of, or not liable to, IHT. It does not matter whether such a gift is in your lifetime or in your Will (so made when you die). It does not matter how big, or large, the gift to your spouse might be there is still no IHT payable.

The **Civil Partnership Act 2004** altered this so a **Civil Partner** will have roughly equivalent rights a spouse would have. This Act allowed the HMRC to introduce Regulations to give the Tax effects to this change and these were announced in the 2005 Budget on the 16<sup>th</sup> of March 2005. This Act came into force on **5<sup>th</sup> of December 2005**. So

on or after the 5<sup>th</sup> of December 2005 once a couple have had their civil partnership registered then a gift by one to the other will have **Spouse Relief** for IHT purposes.

**2. Gifts to spouses who are non domiciled (in the UK)**

A gift to your spouse or civil partner who is non domiciled in the UK has a restricted spouse exemption to the sum of £55,000.00 where

- Where the deceased or the donor is domiciled in the UK **and**
- The transferee spouse or civil partner is **not** domiciled in the UK

and, for the purpose of the exemption, domicile includes deemed domicile even in the case where a pre-1975 Double Taxation Agreement is in point.

**3. The Spousal Nil Rate Band Transfer system**

The Pre Budget Report 2007 on the 9<sup>th</sup> of October 2007 proposed the Spousal Nil Rate Band Transfer system. This is a new relief for IHT where for married couples, or civil partners, the second of them dies **on or after the 9<sup>th</sup> of October 2007**. This proposal was confirmed by the Finance Act 2008 which received Royal Assent on the 18<sup>th</sup> of July 2008.

In essence as we understand it this will work as follows:-

**(A) On the first death** (and the date of death is not important) you will need to ascertain whether the then Nil Rate Band (NRB) was used in that first estate. This will need to be worked out as a percentage.

*Example 1* = So if H leaves 50% of his estate to W and 50% to his children then you have 50% to use on the second death (the unused percentage).

*Example 2* = If H leaves all of his estate to W then you have 100% to use on the second death.

Gifts which have Business Property Relief or Agricultural Property Relief or gifts to charity will need to be taken into account as part of the new Spousal Nil Rate Band Transfer system.

**(B) On the second spouse/civil partner's death which has to be on or after the 9<sup>th</sup> of October 2007** say the NRB was then £325,000 you will have to set against the second estate 100% of the NRB from the second estate **PLUS** a second sum which is the carried forward percentage from the 1st estate.

*Example 1* = So in this example this was 50% of unused NRB in the first estate. So you would have another 50% of the NRB (£325,000). So the second estate would have £487,500 (£325,000 + £162,500) to set against it.

*Example 2* = So in this second example this was 100% of unused NRB in the second estate. *So the second estate would have another 100% of the NRB (£325,000).* So the second estate would have £650,000 (£325,000 + £325,000) to set against it.

In order to claim the Spousal Nil Rate Band Transfer a special claim form (Form IHT 420) will need to be completed and submitted to HMRC.

**4. Gifts to Charities**

A gift, whether in your lifetime or in your Will (when you die), to a (registered UK) Charity will be free of IHT. It does not matter how big the gift to the charity might be.

The 2011 Budget announced that a reduced rate of inheritance tax (IHT) will apply where 10 per cent or more of a deceased's net estate (after deducting IHT exemptions, reliefs and the nil rate band) is left to charity. In those cases the current 40 per cent rate will be reduced to 36 % (instead of the 40% rate). **It is proposed that the new rate will apply where death occurs on or after 6 April 2012.** The Government will be consulting on the detailed implementation of this measure and will issue a consultation document before the summer of 2011. The best way of showing this is in some worked examples.

**1/ Example of the proposed new Charity rate of IHT (after 6<sup>th</sup> April 2012)**

Estate (after allowing for debts)	£625,000
<b>Less Nil Rate Band</b>	£325,000
Net Estate	£300,000
<b>Less 10% of Net Estate given to Charity (so the amount paid to Charity)</b>	£30,000
Estate chargeable to IHT	£270,000

**1/ Example of the proposed new Charity rate of IHT (after 6<sup>th</sup> April 2012)**

IHT payable (on £270,000) at 36%	£97,200
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Amount paid to the beneficiaries is therefore £625,000 less gift to Charity of £30,000 less IHT of £97,200 = **£497,800**

**2/ Compare an example of the current IHT position (up to the 5<sup>th</sup> of April 2012)**

Estate (after allowing for debts)	£625,000
<b>Less Nil Rate Band</b>	<b>£325,000</b>
Net Estate (which is the estate chargeable to IHT)	£300,000
IHT payable (on £300,000) at 40%	£120,000

Amount paid to the beneficiaries is therefore £625,000 less IHT of £120,000 = **£505,000**

In conclusion:-

- The difference for **the Beneficiaries**, in these examples, is **£7,200** (£505,000 less £497,800)
- The difference for **HMRC**, in these examples, is **£22,800** (£120,000 less £97,200)
- So to give to Charity, in these examples, **£30,000** it has "cost" the Beneficiaries £7,200 or put it another way HMRC has paid 76% of the gift made to Charity.

**5. Gifts to Political Parties**

A gift, whether in your lifetime or in your Will (when you die), to a political party will be free of IHT. It does not matter how big the gift might be.

**6. Survival clause in wills**

A clause should be included in the wills specifying that the surviving spouse will not inherit the other's assets unless he/she survives for a period of one to three months.

The clause will avoid needless aggregation of the estates and the payment of excessive inheritance tax if husband and wife die in quick succession.

**7. Will planning - Wills with Trusts**

Consider making gifts to beneficiaries, other than the surviving spouse on the first death, of less than the Nil Rate Band. This will mean that this part of your estate will not be liable to IHT. Furthermore, the assets will not form part of the surviving spouse's estate on his/her subsequent death.

Or you could consider using the nil-rate band on the first death possibly by way of a discretionary trust. See our separate **Client Guide on Wills with Trusts**. This could help with making sure that a surviving spouse does not necessarily completely lose the use of these assets.

When considering whether to use this kind of relief, account must be taken of the standard of living of the surviving spouse.

A Tax Planning Will might include:-

- A Gift of Assets liable to Business Property Relief and/or Agricultural Property Relief (see below) to your children
- A Nil Rate Band Discretionary Trust
- What is left over going to Spouse or Civil Partner if he/she survives you

You should review your Will every two to three years. This is particularly important if your estate may be liable to pay IHT.

**8. House ownership (in England and Wales) (joint tenants and tenants in common)**

Normally, houses are owned as **joint tenants**. This means that on the first death, the survivor automatically received the other's share in the house notwithstanding the terms of any will.

Owning a house as **tenants in common** ensures that your share in the house (say your 50% in the house - the percentage or fraction you hold does not have to be an equal share) will pass according to the terms of your will. Where IHT is a consideration it is probably better to hold the house as **tenants in common**.

If, say, a husband dies in a car accident and the wife dies a few days later it would mean that the individual shares

in the house would be caught by the survival clause (see **Section 1** above) included in the wills and, thus, excessive inheritance tax would be avoided.

**9. Equalisation of estates**

It is beneficial for husband and wife to equalise their estates since then there is scope for each to leave significant assets to the children on the first death, if appropriate.

Also, equalisation of estates can ensure that both husband and wife make use of their nil-rated inheritance tax band (provided that the wills include a survival clause).

**10. Deeds of Variation**

It is possible to vary the distribution of an estate, and provided this is done within two (2) years of the benefactor's death, the variation is treated as having been made by the deceased. Therefore, the surviving spouse can arrange for funds to pass to the children with consequent inheritance tax savings. The "legal fiction" is that the HMRC look on the changes as if they had been made by the deceased immediately before he died (so it is not looked upon for IHT purposes that the person giving up the benefit had made the change).

**11. Potentially Exempt Transfers (PETs) - significant gifts made during your lifetime**

Lifetime transfers to individuals, to trusts in which an individual has an interest in possession or to qualifying accumulation/maintenance trusts are exempt provided that they are survived by seven (7) years and contain no reservation/enjoyment of benefit by the donor. So gifts until you survive for the seven (7) year period are said to be "potentially" exempt transfers (or PETs).

If you survive such a transfers by less than seven years, but more than three years, **taper relief** will apply as long as the value of the gift is equal to or exceeds the nil-rate band (currently £325,000) at the date of death.

<b>Transfer survived by</b>	<b>Charge at reduced % of death rates</b>
3 - 4 years	80%
4 - 5 years	60%
5 - 6 years	40%
6 - 7 years	20%

The IHT charge on lifetime gifts is on the **value** at the date of the gift but using the tax scale in force at the date of death.

When significant lifetime gifts are not tax-free at the time when they are made, for example, because they are made in favour of a discretionary trust, the tax liability is at 50% of the death rates, as long as you survive seven years from the date you make the gift.

**12. Annual IHT exemptions**

Annual IHT exemptions are available to each spouse. The main exemptions are as follows:-

- You can each make gifts of up to **£3,000** each tax year (6th April one year to 5th April the following year). The annual exemption of **£3,000** has been at this amount since 1981. If you make different a number of gifts in any one tax year then please bear in mind that since January 1991 the HMRC changed their advice as to how this would dealt with. Since that date the HMRC will allocate the annual allowance against gifts in chronological order.
- Also, if this exemption is not used in one tax year, it can be carried forward and used only in the following tax year
- You can make as many gifts of up to **£250** to different individuals/bodies in each tax year (but this cannot be added to the £3,000 gift since the 6<sup>th</sup> of April 1981).

**13. Gifts on marriage**

On a child's marriage, each parent can give up to **£5,000** to a child either before or on the occasion of the marriage, but not after it. Each grandparent can give up to **£2,500**, or remoter ancestor, or by one party to the marriage to the other. In any other case the limit is **£1,000**.

**14. Gifts for Maintenance of the Family**

Lifetime gifts for the maintenance of a spouse, child or dependent relative of the Donor are exempted from IHT in certain circumstances. A gift for the maintenance of a spouse, or former spouse is exempt unconditionally. A gift for the maintenance education or training of your child or your spouse's child is exempt, provided that it is for the child's maintenance education or training up to the age of eighteen or until the completion of full-time education if later. Similarly, a gift made for the maintenance education or training of a child who is not in the care of either

parent is exempt. These exemptions are also available for gifts for step-children and adopted children. The gift for the maintenance education or training of an illegitimate child would be exempt on the same terms.

A gift made to a **dependent relative** is exempt to the extent that it makes reasonable provision for the relative's care and maintenance. **Dependent relative** means any relative of yours or your spouse who is unable to maintain himself or herself because of old age or infirmity. It also includes your mother or mother-in-law whether or not she is elderly or infirm, unless she is living with her husband.

### **15. Regular Gifts from income**

Regular gifts from income which do not affect one's standard of living are exempt. You may be asked to show that this is so to the HMRC when you claim the exemption. This is a very useful where you are saving your excess income and not spending it. Often this is claimed where you are paying, say, the premiums on some kind of savings plan for children or grandchildren. This exemption is over and above the annual exemption.

To qualify for this exemption you must show that:-

- A** The transfer was part of your **normal income**.
- B** Taking one year with another it was made out of income
- and C** You were left with sufficient income to maintain your usual standard of living.

Although a lifetime gift may qualify for this exemption the special IHT rule for the **Tax of Gifts with Reservation** may still apply.

A gift is regarded as part of the your **normal expenditure** if its amount and type are consistent with your usual pattern of gifts.

**Normal** is regarded as broadly equivalent to typical or habitual. The first gift in a series can qualify as **normal** provided there is clear evidence that further gifts are intended. Therefore the exemption could cover an initial gift under a Deed of Covenant or some similar regular commitment such as the first of a series of premiums on a Life Insurance Policy. If there is no such evidence but further similar gifts are in fact made the first gift of a series can qualify retrospectively for exemption.

**Income** for the purpose of the exemption means net income after Income Tax and is determined in accordance with the normal accountancy rules (rather than Income Tax Rules). Income is measured **taking one year with another** and accordingly the exemption is not lost merely because of fluctuations of income from one year to another, nor would it be lost if the Donor used income to make a gift, and, having met some exceptional expense, was temporarily obliged to resort to capital to meet ordinary living expenses, the depletion of capital later being made good. In practice the **out of income** test is regarded as satisfied if the Donor can show that he or she could have made the gift out of income after meeting living expenses. Gifts of property other than cash do not qualify for the exemption unless the Donor can show that the property was purchased out of income in order to make the gift.

If you pay premiums on a Life Insurance Policy for the benefit of someone else, this exemption is not available if the Insurance was taken out or varied in association with the purchase of an Annuity on your life.

Please be aware that the HMRC introduced in 2004 a new Form (which is a **D3a**) which has to be submitted in an estate where this IHT exemption is claimed. We suggest you ask Thursfields for a copy of this form if you intend to use this IHT exemption so that you can see what information your Executors will need to provide in your estate. You can assist in your lifetime by ensuring that you keep these records.

### **16. Business relief against IHT or Business Property Relief (BPR)**

If you own a business, not involved in investments, then there are special reliefs available which then reduces the value of the business asset when calculating the IHT on your estate. This is a complicated area and we have not set out here the many factors that have to be taken into consideration for such assets in order to claim any relief that is available. We have briefly set out below various points to bear in mind. Remember this is for businesses carried on for gain that is "qualifying business". You have to have owned the share in the business for more than two (2) years before you died. There are rules, which allow for the sale of business and the purchase of another business.

With effect from the **10th March 1992**, **One hundred per-cent (100%) BPR** applies to the sole-proprietor business, and the interest of a Partner in a business. From the **6th of April 1996 BPR** applies to all qualifying unquoted shareholdings whether or not you have more than twenty-five per-cent (25%) of the voting power. Unquoted securities, like, loan stock can also apply. Most shares held on the Alternative Investment Market (AIM) or Unlisted Security Market are treated as unquoted shares for IHT purposes. Quoted shares (that is quoted on a recognised stock exchange) do not qualify.

Fifty per-cent (50%) **BPR** applies to shares or securities giving control of a "quoted company" and to land, buildings, machinery and plant in a Company of which the Transferor has control, or by a Partnership of which he was a member.

BPR does not apply to **excepted assets** broadly assets, which are not needed by the business. For example an asset is **excepted** unless it was used wholly or mainly in the business throughout the two (2) years preceding the transfer or is required at the time of the transfer for future use in the business. Whether an asset is required for future use is very much a matter of evidence, including development or expansion plans and the capital outlay involved.

Relief is denied if, with certain exceptions, the business is wholly or mainly a business dealing in securities, stocks and shares, land or buildings, or making or holding **investments**. The problem with **investments** is where to draw the line between the mere passive holding of investments and other additional activities. Those additional activities may mean that you do not qualify for relief. These are often difficult cases, which are again a matter of evidence, turning on the facts of each case.

If assets on which BPR was available have been given away as a PET (see Section 9 above) then remember if the PET fails (say you die 5 years after you made the PET) the assets you gave away also have to qualify for BPR at the date of the failed PET. If not then BPR is lost on the gift and IHT is due. So if, say, Dad gives his daughter the family company but his daughter then sells the family company and Dad then dies within 5 years of the gift then there was BPR on the gift originally but when Dad dies daughter no longer owns the asset on which BPR is available so IHT is due on the gift.

Caravan sites are a difficult area where BPR has been refused in several cases but allowed in a few limited cases. If this is your type of business then this will need to be considered carefully with you.

### ***17. Agricultural relief against IHT or Agricultural Property Relief (APR)***

If you involved in agriculture then, again, there are special reliefs available which then reduces the value of the agricultural asset when calculating the IHT on your estate. This is also a complicated area and we have not set out here the many factors that have to be taken into consideration for such assets in order to claim any relief that is available.

**Agricultural property (AP)** normally qualifies for One Hundred per-cent (100%) APR if

- AP is occupied by the Transferor for agricultural purposes for at least two (2) years immediately before the transfer (or date of death), or
- AP is owned by the transferor for more than seven (7) years immediately before the transfer (or date of death) and throughout that period has been occupied for agricultural purposes and the Transferor has the right to vacant possession within twelve (12) months, or
  - The transferor is entitled to his interest on the 9<sup>th</sup> of March 1981, or
  - The AP is let on a Farm Business Tenancy (since the 1<sup>st</sup> of September 1995), or
  - The AP is dedicated to wildlife habitats

Fifty per-cent (50%) APR will apply

- AP is occupied by the Transferor for more two (2) years, or
- AP is owned by the transferor for more than seven (7) years and the Transferor has the right to vacant possession within twenty four (24) months, BUT
- The conditions for 100% APR are not met

The rate of APR for let farmland was increased from Fifty per-cent (50%) to One hundred per-cent (100%) for farmland let on or after the 1st September 1995. Short rotation coppice will count as farmland and farm buildings for transfers on or after the 6th April 1995 and so will be eligible for APR at One hundred per-cent (100%).

APR is not available

- if the AP has not owned for long enough
- if a PET fails but the property would then no longer qualify for APR
- if the property is not agricultural
- the excess of value over its agricultural value

You should not "just" assume that APR will apply. Now, it would be a shock if it did not apply, wouldn't it?

If assets on which APR was available have been given away as a PET (see Section 9 above) then remember if the PET fails (say you die 5 years after you made the PET) the assets you gave away also have to qualify for APR at the date of the failed PET. If not then APR is lost on the gift and IHT is due. So if, say, Dad gives his son the farm but his son then sells the farm and Dad then dies within 5 years of the gift then there was APR on the gift originally but when Dad dies his son no longer owns the asset on which APR is available so IHT is due on the gift.

### 18. APR and Farmhouses

How APR applies to a farmhouse has been contentious for some time. However there are now two cases involving the same family that help to clarify matters.

**Antrobus No 1** was a case before the Special Commissioners in 2002. This helps in the understanding of when a farmhouse is of a character appropriate for that particular farm. Antrobus No 1 gives five (5) tests to help. However these tests are really much the same test but formulated in (slightly) different ways. These five (5) tests are:-

1. The house in relation to the **land** = is it a farmhouse? Or a house on a farm?
2. The house in relation to the (farming) **activity** = is it proportional to the activities conducted?
3. The **Subjective** (elephant) test = you will know one when you see one!
4. The **Objective** test = would the man on the Ambridge (or country) bus say it was one?
5. The **Historical** test = the historical use of the farm (has it always been the same size {which was the case for the Antrobus family} or has part been sold off? or bought? and so on)

Antrobus No 1 still does not make this that certain, or is that just us?

**Antrobus No 2** was a case before the Lands Tribunal in October 2005. This was a case about what is agricultural value. This case seems to have established

- A Farmer is the person who lives in the farmhouse to farm the land comprised in the farm and who farms the land on a day-to-day basis. (Yes, we agree that this does not make much sense!!)
- A Farmhouse is the house in which a Farmer lives
- The Agricultural value of the farmhouse may be 30% less than market value (the facts of the Antrobus case gave that percentage discount between what a **lifestyle farmer** would pay for the farmhouse and what a genuine farmer was prepared to pay for a farmhouse on a working farm).

Lifestyle Farmers are vulnerable to the Antrobus No 2 tests.

The Antrobus cases were followed by the **McKenna** case, in October 2006. The Commissioner in the McKenna case reviewed the legal principles to determine whether a house is farmhouse where it was said - *"That a farmhouse is a dwelling for the farmer from which the farm is managed; that the farmer of the land is the person who farms it on a day-to-day basis rather than the person who is in overall control of the agricultural business conducted on the land; and that the status of the occupier of the premises is not the test but the proper criterion is the purpose of the occupation of the premises"*. The case also went on to consider whether the farmhouse had been occupied for the purposes of agriculture throughout the period of two years ending with the date of death. In the McKenna case the family had been using farm contractors and had they were in a Care Home for some time before they died. In McKenna the decision was, as well, that Mr McKenna had not occupied the property for the purposes of agriculture. Some have argued that McKenna has meant that this will cause difficulties where, say, a farmer has (semi) retired and is leaving in the "farmhouse" (the main house) but his son/daughter is in a smaller property.

So the two Antrobus cases and the McKenna case now mean that:-

1. Is it a farmhouse? If you can answer YES then go to the next question
2. Is it of a character appropriate? If you can answer YES, again, then go to the next question
3. Is it occupied for the purposes of agriculture? If you can answer YES, again, then go to the next question
4. Only if you have answered YES to the three (3) previous questions - What is its agricultural value?

In our experience the Valuation Office Agency (VOA) (formerly the District Valuer or DV) will start by arguing that the agricultural value of a farmhouse is 30% less than the market value for the farmhouse. However do remember that the value of an old barn may be minimal but BPR might be unavailable.

So there is no guarantee on APR on a farmhouse any more. However you should not split the farmhouse from the farmland (say by letting the farmhouse out separately).

**19. Life Assurance**

A joint whole of life policy can be effected **in trust** to pay a tax-exempt sum to the children when the second spouse dies. An annual premium is payable until then and this can be claimed as a regular gift out of income (see Section 7 above).

A convertible term assurance policy offers the option to convert to a low cost whole of life policy at a later date. At modest cost, this arrangement can fund some of the eventual tax liability and a specific illustration is enclosed.

If you own an existing policy or you have a pension policy which is on a return of fund basis you will be able to enter into a trust over that policy to take the proceeds outside of your estate for IHT purposes. The premiums payable can be claimed as a regular gift out of income (see Section 7 above).

**Thursfields** are not registered to offer financial advice. **Thursfields** would advise that if you are interested in Life Assurance that you approach an Independent Financial Advisor (IFA) to help and assist you. As this is a more specialist area Thursfields can recommend a number of IFA's (who understand about IHT planning) for you to take advice from, compare approaches and so on. If we should be paid any commission we would disclose this to you and agree with you how the commission is to be dealt with.

**20. A Major Pitfall - A Gift with Reservation of Benefit ("GROB")**

There may be a **GROB** where **after the 17th March 1986** there is a lifetime gift, and after the gift and within seven (7) years of death the Donor has not been entirely excluded or virtually excluded from possession and enjoyment of the gifted property or from any benefit by Contract or otherwise. Some gifts are expressly excluded from being a **GROB**, for example gifts between spouses, marriage gifts, gifts to Charity and small gifts.

Where the reservation continues to exist at the date of death, the property concerned is treated as part of the Donor's Estate for IHT purposes and is therefore taxed accordingly. If the Donor gives up the **GROB** before the date of death, he or she is treated as having made a potentially exempt transfer at that time.

In practice the most common example of a **GROB** is where a Donor gives away a house but continues to live there. There is a let out. The Donor's continued occupation will be disregarded if the Donee (the recipient of the gift) is paid a full market rent by the Donor. Full consideration is required however throughout the period of occupation. The payment should be reviewed at appropriate intervals to reflect market changes. It is recognised that what amounts to full consideration lies within a range reflecting normal valuation tolerances. Any amount within that range can be accepted as satisfying the test of full consideration.

There will not be a **GROB** if the gift is **virtually to the entire exclusion** of the Donor. **Virtually** is not defined but in practice is it interpreted to cover cases where the benefit to the Donor is insignificant in relation to the gift of property. Illustrations include a house which becomes a Donee's residence, but where the Donor subsequently :-

- ♦ stays in the property in the Donee's absence for not more than two weeks each year.
- or ♦ stays with the Donee for less than two weeks each year.
- or ♦ pays social visits in certain circumstances.
- or ♦ visits for domestic reasons (e.g. babysitting)
- or ♦ stays for some short term purpose (e.g. convalescence after medical treatment)

If the benefit to the Donor is or becomes more significant the **GROB** provisions are likely to apply. An example is where the Donor stays in the house most weekends or for a month or more each year.

Concern about the application of **GROB** rules to **business interests** generally centres on gifts of Shares in a Company where the Donor continues to remain as a Director and be paid Director's remuneration. The test here is whether the arrangement is reasonable and commercially justifiable against what might be expected under "arms length" arrangements between unconnected persons, having regard to matters like the time, effort and expertise devoted to the Company's affairs.

**21. Another Major Concern - Pre owned Assets Tax ("POAT")**

This was announced on the 10<sup>th</sup> of December 2003 in the pre Budget Report as a major piece of what the Government believed to be (IHT) tax avoidance legislation. This new (IHT) tax avoidance measure applies **from the 6<sup>th</sup> of April 2005**. Schedule 15 of the Finance Act 2004 sets out the detail of these new rules.

The POAT would seem to apply, it seems to us, as follows:-

1. You own an asset
2. You give the asset away
3. At some point in the future you have some benefit in the asset again

If you can say “yes” to all three of those conditions then the POAT will apply unless you come within the exemptions. If the POAT applies then there is an Income Tax charge on those gifts of assets where the donor (or giver) retains an interest but which are not caught by the gift with reservation rules (see above).

The POAT will not apply where a donor gives away an outright gift of cash at least seven (7) years before they occupied the land or took possession of the property. This means that if a parent gave a child a cash (or monetary) gift eight (8) years ago and they now occupy a house bought with those funds, no Income Tax charge can arise. However a charge could still apply if the gap between the gift and the occupation was less than seven (7) years.

The Income Tax charge will be reduced if where there is a part sale and part gift. The de minimis figure of tax has increased to £5,000 (originally this was proposed on £2,500).

Further exemptions from the charge have been introduced, for example only:-

- Gifts within the IHT small gifts exemption (see above)
- Gifts within the IHT annual exemption
- Gifts for family maintenance within Section 11 of the Inheritance Tax Act 1984
- Cases where the Donor’s taxable estate for IHT purposes still reflects the value of the gifted assets (for example where the assets were gifted to a company in which the donor owns the shares)

Property comprised in a Settlement is only chargeable where the income is caught by Section 660A by virtue of the settlement and not for any other reason, for example, where a Settlor can switch income into the settlement by waiving the dividend on shares held outside the settlement.

It was originally proposed that a one-off chance (if the donor was liable to Income Tax in 2005 to 2006) to elect to treat these assets in question as still within their estate for IHT purposes. The ability to opt out of the POAT regime has been extended in the Finance Act. An election for the assets to remain part of the donor’s estate can now be by the 31<sup>st</sup> of January after the end of the first tax year to which the POAT rule applies to the donor.

Further amendments were made to original proposals so that the Finance Act, and regulations issued under the Finance Act, clarifies the position of non-domiciled donors. The charge can only apply to a non domiciled taxpayer if the property which they were using or enjoying is situated in the UK. In the case of someone who was previously domiciled outside the UK, the POAT charge does not apply to any asset which is excluded property at the time of enjoyment or occupation.

## ***22. The Finance Act 2006 - The changes to the IHT taxation of Trusts***

The 2006 Budget proposals now affect Trusts **from the 22<sup>nd</sup> of March 2006** (Budget Day). **Budget Note 25** came out of the blue with no prior consultation with the professions or any other interested parties by the then Chancellor, Gordon Brown. These proposals are now in the Finance Act 2006.

**Before** the 21<sup>st</sup> of March 2006 we had, very simply, four (4) main types of trusts

1. Bare Trusts (which were simple but quite rigid structures)
2. Life Interest Trusts (LIT) or Interest in Possession (IIP) Trusts - where some one had an interest for his/her life in the income from the Trust Assets or could have the use of the Trusts Assets for his/her lifetime.
3. Discretionary Trusts (DT)
4. Accumulation & Maintenance Trusts (A & M Trusts)

**On or after** the 22<sup>nd</sup> of March 2006 we now have

1. Bare Trusts (no change)
2. Life Interest Trusts (LIT) (it is probably wrong to use the old Term of an Interest in Possession) -
  - (1) It will **not** be possible to set up in your lifetime LITs anymore free of IHT as a PET. So it will **not** be a PET to transfer assets into a (lifetime) LIT.
  - (2) If any further assets are transferred into an existing LIT on or after the 22<sup>nd</sup> of March 2006 then it will become a **Relevant Property Trust** (RPT) for IHT and will be taxed to IHT accordingly.
  - (3) LITs can be set up in your Will as long as they meet various conditions to be an **Immediate Post Death Interest** (IPDI). If they do not meet those conditions then the LIT will become a **Relevant Property Trust** (RPT) for IHT and will be taxed to IHT accordingly.
  - (4) LITs can be set up by the application of the statutory trusts if you die Intestate as those to meet the various conditions to be a IPDI.
  - (5) For **existing** LITs these are now known as **Transitional Serial Interests** (TSI). All TSIs have until the 6<sup>th</sup> of April 2008 to change the IHT status of such a trust so that has to be a LIT where on the death of any Life Tenant (who is living at 6<sup>th</sup> April 2008) the property will vest absolutely. If this is

not done then the LIT will become a RPT for IHT (after the 6<sup>th</sup> of April 2008) and will be taxed to IHT accordingly.

### 3. DTs and RPTs

- (1) DT's are unchanged for IHT
- (2) RPTs are basically taxed for IHT in a similar way as for a DT so
  - A. IHT is payable on the **Chargeable Transfer** into a DT or RPT at the lifetime IHT rate of 20%. The Nil Rate Band will be set against chargeable transfer and any balance above the Nil Rate Band will be liable to IHT at the lifetime rate of 20%.
  - B. A **10 Yearly Anniversary Charge** to IHT. This is based on the value of the assets in the DT or RPT with those assets revalued (market value) on the 10 Yearly Anniversary. The then Nil Rate Band (whatever that value is on the 10 Yearly Anniversary) is taken away from that revalued total. IHT is then paid on the balance at, currently, a maximum rate of 6%.
  - C. An **Exit Charge** to IHT is payable when any capital is paid out from the DT or RPT (even if this is before the first 10 Year Anniversary). The then Nil Rate Band (whatever that value is at the date of the exit charge) is taken away from that revalued (market value) total of those assets as at the date of the exit charge. IHT is then paid on the balance, currently, at the rate of **0.6%** per year since the RPT was created or since the last 10 Year Anniversary Charge. This would be, currently, a maximum IHT rate of 6%.
  - D. **Hold Over Relief** for Capital Gains Tax (CGT) will be available on capital paid into or leaving the DT or RPT if the appropriate elections are made (though even here there are anti avoidance provisions).

### 4. A & M Trusts

- (1) It will not be possible to set up lifetime A & M Trust anymore free of IHT. So it will **not** be a PET to transfer assets into a lifetime A & M Trust.
- (2) If any further assets are transferred into an existing A & M on or after the 22<sup>nd</sup> of March 2006 then it will become a RPT for IHT and will be taxed to IHT accordingly.
- (3) A & M Trusts can be set up in your Will as long as they meet the conditions to be a **Bereaved Minor Trusts** (BMT). A BMT is simply that your children receive their interests absolutely at age 18. If they do not meet those conditions then the gift will become a **Relevant Property Trust** (RPT) for IHT and will be taxed to IHT accordingly.
- (4) A & M Trusts can be set up by the application of the statutory trusts if you die Intestate as those appear to meet the conditions to be a BMT.
- (5) For **existing** A & M Trusts they have until the 6<sup>th</sup> of April 2008 to change the IHT status of the A & M Trust so that it complies with the new conditions. If that is not done then that existing A & M Trust will become a RPT for IHT (after the 6<sup>th</sup> of April 2008) and be taxed to IHT accordingly.

### 23. Discounted Gifts ("DG")

As part of the discussions with the HMRC about the POAT various investments, usually called **Discounted Gift** arrangements, the offered by the Insurance Companies were considered to see if they were affected by the POAT (as above), and as to whether they would have to pay income tax under the POAT. The HMRC agreed that DG's were not affected by the POAT and so no tax would be imposed on them by the POAT.

DG's, from an IHT planning point of view, offer a discount on the amount of the gift (placed into the DG investment) immediately the DG has been taken out. So there is an immediate saving of IHT. DG's only really will help those clients who have cash to invest or cash investments which could be switched into DG's.

**Thursfields** are **not** registered to offer financial advice. **Thursfields** would advise that if you are interested in DG's that you approach an Independent Financial Advisor (IFA) to help and assist you. As this is a more specialist area Thursfields can recommend a number of IFAs (who understand about IHT planning) for you to take advice from, compare approaches and so on. If we should be paid any commission we would disclose this to you and agree with you how the commission is to be dealt with.

Remember that a DG is still an investment and so poor advice as to choice of company, for example, and that company's subsequent poor performance could be just as much as a problem as reducing the IHT payable on your estate.

Please Note that due to the 2006 Budget some Insurance Companies are waiting for the Finance No2 Bill 2006 to receive Royal Assent (estimated for about the 20<sup>th</sup> of July 2006) before they will relaunch their DG products.

### 24. Loan Trust ("LT")

Loan Trusts again use an investment vehicle to help reduce, in the long run, your IHT liability. They differ from DG's (as above) and again need specialist advice. They have different advantages and disadvantages compared

to DG's.

We would repeat that Thursfields are not registered to offer financial advice. Thursfields would advise that if you are interested in LT's that you approach an Independent Financial Advisor (IFA) to help and assist you. As this is a more specialist area Thursfields can recommend a couple of IFA's (who understand about IHT planning) for you to take advice from.

Remember that a LT is still an investment and so poor advice as to choice of company, for example, and that company's subsequent poor performance could be just as much as a problem as reducing the IHT payable on your estate.

### ***25. Life Insurance***

Traditionally if there is a IHT on your estate you could take out life insurance (usually a whole of life policy) to pay the IHT. To be more accurate this provides a fund to pay the IHT. Such a policy should be "written in trust" so that the proceeds are paid to your beneficiaries direct so that they can then pay the IHT. If the policy is not written in trust then the policy would just be another asset of your estate, and IHT would be payable on the proceeds of the policy as well. This rather misses the point of this arrangement.

### ***26. Other IHT saving Investment Strategies***

Thursfields are not investment advisors however there are various investment strategies that you can adopt to help reduce the effect of IHT on your estate. Thursfields can provide details of various Independent Financial advisors who may be help you further with such IHT saving Investments Strategies.

### ***Historical Nil Rate Band (or Tax Threshold) data***

<b>Date of IHT event on or between</b>	<b>Nil Rate Band (or Tax Threshold)</b>	<b>So two (2) Nil Rate Bands (or Tax Thresholds) amount to...</b>
6 April 1990 and 5 April 1991	£128,000	£256,000
6 April 1991 and 9 March 1992	£140,000	£280,000
10 March 1992 and 5 April 1995	£150,000	£300,000
6 April 1995 and 5 April 1996	£154,000	£358,000
6 April 1996 and 5 April 1997	£200,000	£400,000
6 April 1997 and 5 April 1998	£215,000	£430,000
6 April 1998 and 5 April 1999	£223,000	£446,000
6 April 1999 and 5 April 2000	£231,000	£462,000
6 April 2000 and 5 April 2001	£234,000	£468,000
6 April 2001 and 5 April 2002	£242,000	£484,000
6 April 2002 and 5 April 2003	£250,000	£500,000
6 April 2003 and 5 April 2004	£255,000	£510,000
6 April 2004 and 5 April 2005	£263,000	£526,000
6 April 2005 and 5 April 2006	£275,000	£550,000
6 April 2006 and 5 April 2007	£285,000	£570,000
6 April 2007 and 5 April 2008	£300,000	£600,000
6 April 2008 and 5 April 2009	£312,000	£624,000
On or after 6 April 2009	£325,000	£650,000

### ***Overall advice***

The mitigation of IHT must be discussed with us and kept under review so that a suitable IHT plan is prepared. This is especially the case for a married couple where their Estates, together, are worth **between £325,000 and £650,000**. So, for example, this may mean starting with considering whether you need Will including a Nil Rate Band Discretionary Trust.

Also, in Thursfields view, you also seek the advice of several IFAs, who specialise in IHT planning. There are a number of investments which of themselves have some IHT advantages. Thursfields are not financial advisors but can confidently provide, if you wish us to, the names and contact details of a number of IFAs you can advise you about such matters.

### ***Further Reading?***

Thursfields suggest you also may wish to read and/or use:-

- Thursfields IHT Planning Checklist. This Checklist is to assist in making suggestions for your IHT and to

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provide bullet points for any meeting you have with Thursfields to discuss IHT planning.

- Thursfields **Client Guide** on **Wills with Trusts**

You may wish to visit the Government Web Site for HM Revenue & Customs at [www.hmrc.gov.uk](http://www.hmrc.gov.uk)

*An explanation of some commonly used legal words &/or terms*

- **Accumulation and Maintenance Trust (or an "A & M" Trust)** - A specific type of Trust where income can be saved, rather than being paid out, so "accumulated" OR income (and/or capital) can be used (paid) for "education, maintenance or benefit" of the beneficiaries. For example only, "*monies are to be held for X until he is 25 years of age when he shall be entitled to them absolutely*".
- **Bare Trust** - A simple kind of Trust, sometimes even a verbal trust. For example only, "*Executors agreeing that they hold property in an estate absolutely for the beneficiaries X and Y (in effect the Executors then hold that property as Trustees). So when that asset is sold then the sale is made for X and Y personally*". So this can be important, for example, for Capital Gains Tax reasons.
- **Bereaved Minor Trust (BMT)** - A new definition for a specific kind of trust created in a Will or under the statutory trusts that apply on an Intestacy for children since the 22<sup>nd</sup> of March 2006.
- **Civil Partner & Civil Partnership** - The **Civil Partnership Act 2004** defines these terms for formal same sex relationships. The **Civil Partnership Act 2004** came into force on the **5<sup>th</sup> of December 2005**
- **Deed of Trust** - The name for a document (or deed) which establishes the Trust (usually used for a Trust created in your lifetime).
- **Discretionary Trust (DT)** - A specific type of Trust where income and/or capital can be saved, or paid out, as the Trustees decide for the beneficiaries. For example only, "*monies are to be held for X and Y and Z but the income can be saved or paid out between them equally or unequally and the capital can be invested and/or paid out to them equally or unequally*". So there may be IHT payable on assets passing into a DT, there will be a 10 Yearly IHT Anniversary charge to IHT and an Exit IHT charge on capital passing out of the DT.
- **Hold Over Relief** - This is a Capital Gains Tax (CGT) election on assets passing into a DT or a RPT or leaving a DT or RPT. The effect of the Hold Over Relief is that anyone who then receives that asset takes it at the base value of the transferor of the asset not the market value at the date of the transfer.
- **Immediate Post Death Interest (IPDI)** - A new definition for a specific kind Life Interest Trust for a Spouse or Civil Partner since the 22<sup>nd</sup> of March 2006.
- **Interest in Possession Trust** - The term used for a **Life Interest Trust** that used to be used under the IHT legislation up to the 21<sup>st</sup> of March 2006..
- **Life Interest Trust (LIT)** - A specific type of trust where income must be paid to the **life tenant** and when the life tenant dies the assets pass to the beneficiaries specified. For example only, "*monies are to be held for X who can use them for his lifetime and/or can have the income from them for his lifetime and when X dies they shall belong to Y*". **Note:** The IHT benefits for gifts into new (lifetime) Life Interest Trusts ceased from the 22<sup>nd</sup> of March 2006. All existing LITs (at 21<sup>st</sup> March 2006) have until the 6<sup>th</sup> of April 2008 to comply with the 2006 Budget proposals and failing that they will then be treated as Relevant Property Trusts for IHT.
- **Nil Rate Band** - The amount, for a person, that is exempt from paying IHT on lifetime gifts or on death (see above).
- **Nil Rate Band Trust (NRDT)** - A Discretionary Trust included in your Will, which is equal to, or less than, the Nil Rate Band for IHT.
- **Relevant Property Trust (RPT)** - A new definition for most trusts since the 22<sup>nd</sup> of March 2006. They are treated for IHT as similar to Discretionary Trusts. So there may be IHT payable on assets passing into a RPT, there will be a 10 Yearly IHT Anniversary Charge to IHT and an Exit IHT charge on capital passing out of the RPT.
- **Tax Threshold** - Another name for the Nil Rate Band.
- **Trust** - Is the name for a binding obligation undertaken by people (that is to say the Trustees) for various (specified) assets on such terms, or conditions, stated by the Settlor (or Testator if in a Will) for a specified beneficiary or beneficiaries.
- **Trust Deed** - The name for a document (or deed) which establishes the Trust (usually used for a Trust created in your lifetime).
- **Trustee(s)** - They are people who have the responsibility to carry out the terms of the Trust. You cannot have more than four (4) Trustees. Normally Trustees act unanimously. Occasionally the Trust Deed allow majority voting.
- **Will** - A document containing a person's wishes on their death. This must comply with the statutory requirements for it to be a "Will".
- **Will Trust** - A "Will" which contains a Trust (usually an on-going trust).