2015/2016

Inheritance Tax

SIMPLIFIED

"Excellent."
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and Ray L Best

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The Concepts

The concepts of estate planning and inheritance tax mitigation, and the importance of wills and liquidity planning

Inheritance tax planning is part of the general estate planning process. Once the estate assets and liabilities are known, these can be viewed against available exemptions and deductions, as well as dispositions made through a will and the setting up of trusts. Estate planning can occur before and after death. Whether you have made a will or not, your estate can be varied after you have died, so long as various criteria are met, and this is known as a Deed of Variation. Incredible though it may seem, your will can be rewritten up to two years after you have died, but you must have had one in the first place. If you did not, then you would die intestate. Intestate estates can also be varied in this way, but in the absence of a specific will to amend the process can be much more complicated.

Estate assets

During your lifetime you accumulate assets, either in your own name or in joint names, usually with a spouse or partner, but it can be jointly with an unrelated third party. You may have gifted assets to children or others, and if you die too soon after making a gift in this way, then those gifted assets will fall back into estate and may become taxable.

On your death, your assets are brought into account at fair market value, and are then available for distribution, after paying liabilities such as your share of the mortgage and your debts, and last expenses, such as medical and funeral costs, and any taxes such as outstanding income tax and inheritance taxes that may be payable.

Debts that die with you and those that don’t

You will be happy to know that some debts and taxes may die with you and are not payable from your estate. Capital gains tax dies with you and does not become payable, so if you can defer a capital gain and the tax on it until you die,

it need not be payable. If you are in an IVA (individual voluntary arrangement with your creditors), then this debt or commitment also dies with you. However, other debts that you may not be aware of that affect your estate position, would include salaries and amounts owing to employees, if you were a sole trader at the time of death – those employees would have a claim against your estate. Also, if divorced, with a contractual liability for maintenance payments to a former spouse, these do not necessarily end on your death, and there could be a claim against your estate for a lump sum payment.

Wills as core to estate planning

Once your estate has been settled, the assets that remain can pass to your beneficiaries either by will, or if you do not have a will, through what is known as intestacy. The will is the most important mechanism of estate planning and does a number of things.

1. The will directs where you wish your assets to go. Assets can devolve to anyone you name or a charity, or be directed into a will trust, to be administered by your trustees, for the benefit of the beneficiaries.
2. The will gives investment powers to executors and trustees. These are usually framed broadly and flexibly to take any contingency into consideration.
3. The will tells your executors whether you wish to be buried or cremated and whether you are an organ donor. It is important that an up-to-date will be immediately at hand on death so that your wishes may be carried out effectively. If you are leaving organs to science or for medical purposes, it would help to have a donor card.
4. Importantly, the will nominates a guardian for your minor children. This clause only comes into effect if both natural parents have died, and there are children under the age of 18. If you do not nominate a guardian for your minor children, by default the State is the upper guardian, and will do so. It is unwise to nominate the elderly (such as your parents), as bringing up youngsters may not be on their agenda for a happy retirement – choose someone your own age, if at all possible. I would encourage a monetary bequest to the nominated guardian (if the guardianship is accepted) as taking on a new brood of someone else’s children can be an expensive business.
5. The will can deal with business assets, and should mention any shareholder or partner agreements that it is aligned with.
6. The will allows for fees and charges to be made against the estate for professional administration and executorship purposes.

7. The will must be in writing and witnessed by two independent witnesses who will not inherit from you and are aged over 18 and of sound mind.
8. Whilst you can change your will yourself at any time while you are alive, your heirs can also change it for you after death, through a deed of variation. Divorce and remarriage automatically revokes a will – so review your wills as often as possible.

People often express doubts about making a will. 'I don't have anything to leave to anyone, so why should I have a will?' they sometimes ask – or, 'If I die intestate (without a will), the same people will inherit from me, so why bother with a will?' – or, 'If you can rewrite my will after I have died, what's the point in having one in the first place?' The big issue of costs also arises. Wills can be expensive, depending on where you go for one. Also consider a lasting power of attorney (LPA) to be done at the same time as your will. This enables someone to deal with your affairs should you be injured or sick or disabled or mentally incapable and unable to do so. From October 2007 you will have to apply to the Court of Protection to get an LPA, and this will be more expensive than the previous Enduring Power of Attorney (EPA) regime. If you have an EPA it remains valid.

To answer the above questions will give peace of mind to those currently without wills or whose wills may need to be changed due to changes in personal circumstances. The range of will-providers includes solicitors, wills companies specialising in drafting wills, and banks. You can also do it yourself through the internet or using a will form from a stationers. Wherever you go to have your wills drafted, wills are important as an estate planning mechanism. You may not have any assets now, but may inherit in the future; you may have a pension fund and wish to leave it to your heirs; you may have minor children and require guardians to be nominated; you may wish to set up a trust in your will to protect vulnerable beneficiaries who could squander assets if not protected. Above all, you have an opportunity to direct what assets you may have to your relatives or to a charity. Having a will is therefore most important.

For the estate planner advising you, a will can be effective in inheritance tax planning. For example, assets left to one spouse or civil partner by another are free of inheritance tax (the spouse exemption); you can make use of an additional 'nil rate band' exemption through leaving assets in trust to the value of the nil rate band. This effectively bypasses the spouse or civil partner estate for the benefit of the children, for example, thus currently saving £130,000 in inheritance taxes. Simple will clauses can save your estate a lot of money. Whilst the spouse exemption and nil rate band bypass trust can be accessed through a deed of variation after you have died at present, this may not always be the case in the future, and depending on where you get your advice, it may not even be mentioned that it is possible to do so. Therefore plan as best you can, leaving nothing to chance. You may transfer your NRB to enable full use

of both spouses' or civil partners' NRB. Also bear in mind the attack on multiple trusts in 2014 (where it was proposed that only one nil rate band may be available for multiple trusts). This decision has been reversed – however, this this could still come in with later consultation as the Government has stated it will introduce new rules to target avoidance through the use of multiple trusts in the *Finance Bill 2015*.

Cohabitees

The will is one of the most important components of successful estate planning. It is also important if you are not married but cohabiting. It is likely that a significant proportion of the readers of this book will not be married, but living together. For them, there is no spouse or civil partner exemption. There may be a financial dependency to a claim of partner's assets on death, though, but this has to be proved. *The Inheritance (Provision for Family Dependants) Act 1975* allows the survivor in a cohabiting relationship to apply to the Court for reasonable maintenance from the estate. Also the *Law Reform (Succession) Act 1995* allows for an application for maintenance. As the surviving partner is not a spouse, there will not be any widow's or widower's benefits from a pension fund; nor will there normally be any death benefits distributable to them (although some pension funds do accommodate a letter of wishes, enabling certain payments to be made to financially dependant cohabitees). If at all possible nominate the non-spouse for death benefits. The new *Inheritance and Trustees' Powers Act 2014*, which came into force on 1 October 2014 did not make the expected changes for cohabiting spouses to inherit on intestacy.

The unfairness of the present system will affect many cohabitees who are not married or in a civil partnership, when it comes to inheriting assets from a partner. The intestacy laws will be particularly harsh, if you do not have a will, and you will not inherit at all. Only spouses and civil partners have that opportunity. Not being married or in a civil partnership is therefore severely penalised by legal restrictions, and where an unmarried partner (or one not in civil partnership) leaves assets to a partner, these assets will be subject to 40% inheritance tax above the nil rate band. A married or civil partner will have the spouse exemption and no inheritance tax is payable on the first death. Unfair? Yes, absolutely!

The legal case of the Burden sisters [*Burden v United Kingdom 2008 STC 1305*] featured a pair of elderly sisters living together who tried to get clarification on whether the Civil Partnership Act (introduced in November 2004) applied to them as living together and being of the same sex. At the appeal hearing at the European Court of Human Rights, 15 out of 17 judges stated the sisters had not faced unfair discrimination, on the basis that their relationship of co-habitation, despite its long duration, fundamentally differed

from that of a married or civil partnership couple. IHT mitigation planning is essential and they, for example, could (i) downsize (ii) do equity release and invest into a DGT (discounted gift trust) for immediate IHT out of the estate, or a loan trust (iii) release capital and make gifts (even into trust for themselves) – to reduce the property value to below the nil rate band.

The laws of intestacy

If you do not have a will, then your assets devolve according to the laws of intestacy. These laws are slightly different in Scotland and Northern Ireland as opposed to England and Wales. If you do not have a will, then you could find yourself not inheriting at all, or sharing the late dearly-departed's assets with family relatives, such as brothers, sisters, uncles, aunts, grandparents and the like. In the final analysis, even the Duchy of Cornwall can inherit from you, if you leave no relatives.

The **rules of intestacy (England and Wales)** changed for deaths after 1st October 2014. The new Inheritance and Trustees Powers Act 2014 (ITPSA 2014) made a number of reforms. The single biggest change is to rules affecting married couples and civil partnerships where there are no children. In the past, they received the first £450,000 from the estate with the rest split between the deceased's blood relatives. Under the new law, the surviving spouse will receive everything with wider family members not receiving anything from the estate. Another important change affects couples who have children. Under the old rules, the spouse of the deceased received the first £250,000 and a 'life interest' in half of the remainder with the children splitting the other half. Under the new rules, the life interest concept is to be abolished with the surviving married partner receiving the first £250,000 and also half of any remainder. The children will receive half of anything above £250,000 and will have to wait until they are 18 to access any funds

After the payment of funeral expenses, tax and other debts owed by the deceased, the rest of the estate will devolve as follows: *(note that children includes children born in or out of wedlock and legally adopted children, but not step-children)*

- If the deceased leaves a spouse or civil partner, and no children or parents or brothers or sisters of the whole blood – then everything goes to the spouse or civil partner.

- If the deceased leaves a spouse or civil partner and children:

  1. For net estates of up to £250,000 – everything goes to the spouse or civil partner.
  2. For net estates of over £250,000 – the first £250,000 'statutory legacy' (index linked) plus personal chattels (possessions) goes to the spouse

or civil partner; the balance of the estate is divided equally between the spouse or civil partner (50%) and the children at age 18 (50% shared equally).

- If the deceased leaves a spouse/civil partner and no children, and either parents, or brothers and sisters of the whole blood, the spouse receives the whole estate.
- If the deceased leaves children, but no spouse or civil partner, everything goes to the children in equal shares.
- If the deceased leaves no spouse or issue, the estate will pass to the deceased's parents. If neither parent is alive, the deceased's nearest relatives will inherit. The order of priority is as follows:
    1. Brothers and sisters, of the whole blood and the issue of any who have predeceased
    2. Half-brothers and half-sisters and the issue of any who have predeceased
    3. Grandparents
    4. Aunts and uncles (being brothers and sisters of the whole blood of a parent of the intestate) and the issue of any who have predeceased
    5. Half-brothers and half-sisters of the deceased's parents and the issue of any deceased half-uncle or half-aunt.
- If no living beneficiary, the deceased's estate will pass to the Crown, the Duchy of Lancaster or the Duchy of Cornwall.

The following article appeared in *Tax Insider* in November 2014 and shows the changes made:

Tony Granger examines the new intestacy rules which became effective on 1st October 2014, and what changes have been made following the Inheritance and Trustees Powers Act 2014 (ITPSA 2014).

Over 70% of eligible UK residents do not have a will. In addition, some existing wills may be invalid or out of date due to marriage, divorce, death of a spouse. If you do not have a valid will then on your death your assets will devolve according to the rules of intestacy. Under the reforms a larger portion of the estate will pass to the surviving spouse outright and matters are further simplified without a complicated trust structure, which is to be welcomed.

Note the term 'spouse' includes 'civil partner'.

The Changes

The new intestacy rules mean changes for spouses and children where the assets of people who die without wills are shared out. The previous position was that a surviving spouse with no surviving children shared the estate with the deceased's relatives (parents, brothers and sisters and others) where the estate value was greater than £450,000. Under the revised rules, the spouse could inherit the whole deceased estate without sharing it.

Previously, where the deceased left a spouse and children, the estate was shared with him or her and the children. For estates larger than £250,000 the survivor received £250,000 as a statutory legacy and a life interest in 50% of the residue – children being entitled to the remaining 50% on attaining the age of 18. From 1 October 2014 the surviving spouse receives 50% of the residue outright, not only the income. If no spouse, children or relatives, everything goes to the Crown, the Duchy of Lancaster (the Queen) or the Duchy of Cornwall (Prince Charles).

Table showing previous and current intestacy rules

Deceased dies leaving	***Previous – before 1 October 2014***	***After 1 October 2014***
A spouse and children	*Spouse receives:* • *Statutory legacy of £250,000* • *Personal chattels* • *Life interest in 50% of the residue* • *Children entitled to remaining 50% of residue at age 18*	*Spouse receives:* • *Statutory legacy of £250,000 (which is index linked)* • *Personal chattels* • *50% of the estate outright* • *Children entitled to remaining 50% of the residue at age 18*
A spouse, no children, with surviving parents and/or siblings	*Spouse receives:* • *Statutory legacy of £450,000* • *Personal chattels* • *50% of the residue* *Parents receive 50% of residue equally, then siblings if no parents*	*Spouse receives the whole estate* *Parents, siblings (brothers and sisters) receive nothing*

No spouse, but children	*All to children in equal shares*	*All to children in equal shares*
No spouse, children or relatives	*Everything goes to the Crown*	*Everything goes to the Crown*

Unmarried Partners

The revised intestacy rules do nothing for unmarried partners, who receive nothing on intestacy. You may, however, have a claim under the Inheritance (Provision for Family and Dependents) Act 1975. The act specifies four categories of claimants:

The surviving spouse; cohabitee who lived with the deceased for at least two years; Children; legitimate, illegitimate or adopted; and any other child, such as a stepchild, supported by the deceased and treated as her or his own; Others supported by the deceased such as an elderly relative, or anyone receiving regular maintenance from the deceased.

The time limits to bring a claim are very strict, with the Act providing that a claim must be brought within 6 months of the grant of probate being issued.

Inheritance Tax (IHT)

IHT is payable on intestate estates at 40% of the net estate after deduction of applicable nil rate band – currently £325,000 plus the unused portion of a deceased's spouse nil rate band.

Tax Tip

Consider making or reviewing your will. This will give you direction and certainty and ensure that intended beneficiaries benefit from you. IHT savings could be made, and if no relatives remain then a charity could benefit instead of Prince Charles or the Queen.'

The Changes

- *Where a couple is married, the whole estate passes on intestacy to the surviving spouse in all cases where there are no children or descendants.*
- *Where there are children, both spouse and children inherit outright. There is no longer interest payable to the spouse on the children's half. If under age 18 their share is held in statutory trusts, and interest accrues from the date of death at the Bank of England base rate.*

- *The new Inheritance and Trustees Powers Act 2014 (ITPA 2014) will protect children from the risk of losing an inheritance from a parent in the event that they are adopted after the death of that parent; amend the rules that currently disadvantage unmarried fathers when a child dies intestate; reform trustees' statutory powers to use income and capital for the benefit of beneficiaries (subject to any express provisions in the trust document).*

- *There is a new modernised statutory definition of personal chattels under s55(1)(x) of the AEA 1925 which covers all tangible movable property other than any such property which consists of money or securities for money, or property used at the death of the intestate solely or mainly for business purposes, or was held at the death of the intestate solely as an investment.*

- *Under the Inheritance (Provision for Family and Dependants) Act 1975, A person who was maintained by the deceased immediately before the death will be eligible to claim under the IPFDA 1975 whether or not, beyond the fact of providing maintenance, the deceased had formally assumed responsibility for that person's maintenance. A person claiming as a dependant under the IPFDA 1975 need no longer show that the deceased contributed more to the relationship than the applicant did.*

- *In a judgment handed down by the Court of Appeal in July 2015 (Illott v Mitson [2015] EWCA, the Court awarded £163,000 to Heather Ilott, the daughter of Melita Jackson who left her £486,000 net estate to three charities. Despite a letter written by the deceased explaining the decision on beneficiaries, the court overruled the will. The legislation cited in the case – the Inheritance (Provision for Family and Dependent)s Act 1975 – only applies to the estate of a deceased and not to a trust. The courts have always had the power to overrule or ignore a will if they deem it unreasonable. It is stipulated in the Inheritance Family and Dependants Act 1975. If for example you have multiple children and leave an inheritance to only two and not the third, the courts can overrule this.*

- *One of the proposed changes did not happen. It was expected that co-habiting persons would receive automatic rights on death to intestate assets if they had children or had been together for 2- 5 years. To ensure a co-habitee inherits, the only two ways are marriage or making a will.*

Converting Intestacy income to a lump sum

This was possible where there was a life interest arising under an intestacy for a surviving spouse. The future stream of interest income could be capitalized for a lump sum (S47A of AEA 1925) which had to be elected within 12 months of the grant date of Letters of Administration. Under the new rules, the surviving spouse inherits outright and no longer receives income/interest from

the child's portion of capital, so the income capitalization to a lump sum will become irrelevant.

Common law wives

They obtain no benefit under the intestacy rules although anyone financially dependant on the deceased can make a claim for financial provision out of the estate under the *Inheritance (Provision for Family Dependants) Act 1975*.

Post-death deeds of variation

These can be made within 2 years of the date of death, whether there was a will, or on intestacy. The will is effectively re-written to make use of IHT exemptions not utilised before. All beneficiaries must be aged over 18 and must agree. The Government is to carry out review into IHT avoidance (Budget 2015) through deeds of variation. It feels that using deeds of variation may be a form of avoiding IHT.

Estate planning

Estate Planning is the planning procedure whereby accumulated assets are used for income in retirement and long-term care; where assets are protected from the ravages of inflation and death and other taxes; where beneficiaries are protected and provided for; where on death, assets and future income streams devolve where you want them to go. Estate planning covers all age groups and social classes, and can begin at any time. Wealth preservation and asset protection for future generations is important to most people, as is providing for the maintenance and welfare of your loved ones and possibly even children and grandchildren yet to be born. Estate planning includes your personal as well as your business assets. Reducing liabilities and mitigating taxes is part of the estate planning process, meaning that you keep more of what you have.

Having enough cash

One of the most important aspects of successful estate planning is to have sufficient liquidity – usually cash, but it can be easily realisable investments – available in your estate to provide for inheritances, to fund trusts that you may set up, to pay estate liabilities, such as mortgage loans, inheritance taxes, contractual and other financial commitments. You will have assets that are not liquid – such as the family home or holiday cottage, shares in the business that are difficult to realise, or assets such as well-performing investments that you would not dispose of under normal circumstances. For example, you would

not want the family home to be sold in order to pay inheritance taxes. Nor would you want a top-performing investment portfolio to be encashed, when future income is required from it. Cash can be provided through life assurance in most instances, when more liquid investments are not available. You would use a joint-life second death policy, underwritten in trust. The proceeds of the policy would be payable outside of your taxable estate and would escape probate, being immediately available to meet your liabilities and commitments.

Does your plan work?

Proper planning is essential. In the past twenty-five years I have come across plenty of estate planning clients who have perfect wills in theory, which in practice just do not work. Many wills are drawn up without regard to estate planning, and in particular liquidity planning, and completed without a realistic outcome.

Example

Mr Bobbitt, who is aged 37 now and a successful business owner, wishes to leave £100,000 to each of his three children on his death, £500,000 into trust to provide an income for his beloved Mrs Bobbitt, and a further trust amount of £300,000 for his elderly parents to help them with their long-term care as they cannot survive on the State Pension alone. He also has an inheritance tax liability of £250,000. How much cash or investment assets does he require on his death? A total of £1,350,000. He has private company shares worth £1 million, a house worth £450,000 and ISA investments of £150,000. Cash at bank is £30,000.

On his untimely demise from a heart attack on the 14th tee on his favourite golf course, his accountant cannot find anyone to purchase his private company shares (he was the brains behind the business and had the business contacts, so there was really no business without him) and the shares drop in value for a fire sale value at £300,000 – but still there are no takers. The family still need to live in the house, although they could downsize to release some cash. His total liquid assets are thus ISAs of £150,000 and cash of £30,000, making some £180,000 in total. Barely enough to pay his inheritance tax liability, let alone fund the two trusts or make legacy payments to the children. Result: dreams shattered – not uncommon. However, with simple liquidity planning, at his age, he could have had £1 million worth of life cover to provide cash in the estate, as follows:

Maximum cover whole-of-life: Premium cost is £57 per month for £1 million whole-of-life cover (premiums are reviewable after ten years).

Balanced cover whole-of-life: Premium cost is £272 to £449 per month for £1 million whole-of-life cover (premiums are reviewable after ten years, but the policy reserve is better than maximum cover and any premium increases may be lower).

Guaranteed whole-of-life cover: Premium cost is £492 per month for £1 million guaranteed cover with no reviews.

Level Term assurance cover to the age of 65: Premium cost is £67.51 per month for guaranteed premiums and cover.

Premium costs vary greatly depending on the type of life cover selected. I have included term cover to the age of 65, to provide for family protection over the period up to retirement, as alternative IHT reduction strategies could be in place after that period, and he may require lower-costed but guaranteed outcomes over the planning period.

Note that all life policies should be written in to trust to avoid IHT on the policy proceeds.

Alternatively, he could have planned to reduce liabilities such as the inheritance tax payable; he could have made provision now for his parents for when they get older; he could have funded a pension plan for his spouse's income with tax-deductible contributions (depending on her tax rate), and taken advantage of a number of other cash and income-producing possibilities thus reducing his reliance on life assurance as the only answer. The result: his will would work – and he would die happy.

Inheritance Tax Simplified provides a practical guide to inheritance tax and estate planning, packed with examples and advice on how to reduce the tax paid by both settlor and beneficiaries.

This annually updated guide examines all the options under the latest legislation. It provides detailed practical advice on all the best financial planning devices and tactics to save you and your family money.

Areas covered include:

- inheritance tax rules and regulations
- practical advice on estate planning
- trusts (how they work, and which type to choose)
- how not to lose your house whilst staying in it
- how to preserve and protect your estate assets
- how wills work and why you should have one
- how to make substantial savings at very low cost

……..and a host of other relevant information.

"I am delighted to be able to write a preface to this excellent publication. My hope is that after reading this you will feel better prepared to take decisions on your own inheritance tax needs."

Carole Nicholls FCII FPCS,
former President of the Personal Finance Society

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