Foresight

ER FUTURE

THE FORESIGHT GUIDE:

INHERITANCE TAX

2023/24

The Basics

The number of individuals caught by Inheritance Tax (IHT) is at an all-time high with £5.5bn received by HM Revenue & Customs (HMRC) from April 2021 to February 2022. The reason for the increase year on year is largely due to property price inflation outstripping reliefs and exemptions available to investors.

The current Nil-Rate Band (NRB) of £325,000 has not changed since 2009. What's more, the current £3,000 annual exemption available to individuals hasn't changed since 1981 - over 40 years ago!

An Individual's Estate

To calculate whether an individual's estate will be liable for IHT we have to first work out the value. In simple terms the value of an individual's estate is calculated by:

1. **Adding up all assets owned**
2. **Deducting total liabilities owed**

The amount remaining is the individual's estate.

IHT Cost

Each individual has a Nil-Rate Band (NRB) available to them which is the value of assets that can be passed to beneficiaries tax free.

The current value of the NRB is £325,000 and this rate is fixed until 5th April 2026.

Assets beyond this amount are liable to IHT at 40%.

Example (2022/23 tax year)

Bob is single with an estate valued at **£600,000** made up of one property owned outright. On death he leaves this property to his son, Ryan.

Through a combination of the NRB and the Residence NRB (RNRB) the first £500,000 is free from IHT with the balance of £100,000 chargeable at 40% IHT, equating to £40,000.

PROPERTY VALUE:	**£600,000**
NRB:	**£325,000**
RNRB:	**£175,000**
ESTATE LIABLE FOR IHT:	**£100,000**
IHT AT 40%:	**£40,000**

Ryan Inherits: £560,000

The 7 Year Rule

IHT is coined a cumulative tax meaning it can apply to transfers both during an individual's lifetime and on their death. All transfers made over the 7 years prior to death will be added up and (with exception to a limited number of exemptions and reliefs) will occupy the NRB.

Using the example above let's assume Bob had made a gift of **£50,000** just prior to his death. **In this instance his available NRB would be reduced to £275,000 (£325,000 less the £50,000 gift).**

TOTAL ESTATE:	**£600,000**
GIFT:	**£50,000**
AVAILABLE NRB:	**£275,000 (£325,000 - £50,000)**
RNRB:	**£175,000**
ESTATE LIABLE FOR IHT:	**£150,000**
IHT AT 40%:	**£60,000**

Ryan's inheritance after tax: £540,000

The example above is called a Potential Exempt Transfer (PET) as the gift is only chargeable if Bob dies within 7 years. After this time his NRB is restored to the full amount.

Main Exemptions

Marital Status

Transfers between spouses (or civil partners) made both during life and on death are exempt from IHT. In addition to this the surviving spouse can inherit both NRB and RNRB.

Nil-Rate Band (NRB)

The NRB is the value of assets that, on death, can be passed to beneficiaries free of inheritance tax. Since 2009 the NRB has been frozen at £325,000. For married couples and civil partnerships, any allowance that remains unused on death can be transferred to the surviving partner, meaning qualifying survivors can pass up to £650,000 to beneficiaries free of IHT.

Main Residence Nil-Rate Band (RNRB)

Property price inflation is one of the key reasons IHT is now applicable to more individuals than ever. To help counter this the Government introduced a RNRB in 2017 which promises to provide married couples (and civil partners) an inheritance tax-free allowance of £1m when combined with their existing NRB. Whilst a useful addition there are a few caveats to this new allowance that individuals should be aware of:

- Individuals who downsize (or sell outright) after July 2015 retain the RNRB to the full value of the original property assuming assets of an equivalent value will be transferred
- The allowance is tapered away for estates with a value of over £2m. The allowance tapers away on a 2:1 basis
- The allowance is only available to individuals who are passing their estate to direct descendants therefore individuals with no children cannot benefit from the relief

Annual Exemption

Individuals may make transfers exempt from IHT up to £3,000 in any one tax year with the ability to carry forward the previous year's allowance for one year if not already utilised.

Small Gift

Individuals may gift up to £250 to any number of parties (other than an individual in receipt of the annual exemption referenced above) in any one tax year.

Normal Expenditure

An often overlooked exemption is the normal expenditure exemption. This area of planning can be quite complex but generally if a transfer is part of a donor's normal expenditure, is made out of income and doesn't affect their usual living standard, it will be exempt from IHT. Financial guidance should be sought in relation to this exemption.

Wedding Gifts

For those getting married or entering into civil partnerships individuals can gift:

- £5,000 if the donor is parent to either party
- £2,500 if the donor is a grandparent or made from the bride or groom to the prospective spouse
- £1,000 if the donor is any other person

Business Relief (BR)

Introduced in 1976, BR is a tax relief provided by the UK Government as an incentive to increase investment in certain types of trading businesses.

BR is available on businesses, on an interest in a business or a partnership, on unquoted shares and on land, buildings, plant and machinery when utilised in a qualifying trading business.

Pensions

There is a common misconception that, following the changes made in 2014, assets left in an individual's Government-approved pension will be free from tax when passed to their beneficiaries. Whilst now true for IHT it is important to consider the wider tax implications. The first thing to look at is the type of pension:

Defined Benefit
Spouse and dependent benefits will be determined by the scheme. Unless transferred a defined benefit pension cannot be left to beneficiaries (other than a surviving spouse or a child under the age of 23) on death meaning it's largely ill-suited for IHT planning.

Defined Contribution
This type of pension is the most common with investors able to access up to 25% of their pension pot tax free after the age of 55 with the balance being taxable at the investor's marginal rate. The undrawn pot of cash can be passed on to beneficiaries free from IHT but may suffer income tax in the hands of the beneficiaries depending on their tax position.

- If an investor dies **prior to their 75th** birthday the proceeds are passed on free from income tax and IHT to their beneficiaries
- If an investor dies **after their 75th** birthday the proceeds are passed on free from IHT but beneficiaries will have to pay income tax at their marginal rates i.e. 20%, 40% or 45%

Agricultural Property Relief (APR)

APR is similar to BR, meaning some agricultural property can be passed on free from IHT either during the owner's lifetime or as part of their will.

The qualification criteria for APR is quite complex and tax advice should be sought by individuals looking to make use of this relief.

APR can provide relief at rates of 50% and 100% depending on the type of agricultural property and when the property was transferred.

Individual Savings Account (ISA)

With exception to some AIM based stocks ISAs are fully chargeable for IHT when passed to beneficiaries. Whilst AIM can offer a shelter from IHT it is generally considered a volatile market meaning it may be inappropriate to investors depending on their attitude to risk.

The Government's new Lifetime Savings Allowance (LISA) is also chargeable for IHT purposes.

The Four Pillars of IHT Planning

1. Reliefs

There are several reliefs available to investors offering up to 100% relief from IHT effectively making the transaction entirely exempt. The main reliefs are Business Relief (BR), Agricultural Property Relief (APR) and woodlands relief.

Most unquoted trading businesses qualify for BR with the exception of those whose activities are wholly or mainly in securities, stocks/shares and land/buildings. Unlike several trust based alternatives, BR and APR allow the investor to maintain access and control over their assets.

An investment in qualifying unquoted shares qualifies for 100% BR after 2 years and can then be gifted without impacting on an individual's NRB (though if transferred on death, the value would still form part of the individual's estate in calculating any tapering of the Residence NRB).

2. Gifting

Potentially Exempt Transfers (PETs)
Most gifts to individuals and certain trusts are subject to PET rules. These types of transfers receive taper relief meaning the amount of IHT due reduces over time until, after 7 years, there is no charge. Taper relief is only available where the value of the gift(s) exceed the Nil-Rate Band (NRB).

YEARS BETWEEN DATE OF GIFT AND DEATH	REDUCTION
3 - 4	**20%**
4 - 5	**40%**
5 - 6	**60%**
6 - 7	**80%**
OVER 7	**100%**

Gifts with Reservation
In addition to watching out for PET charges settlors need to be mindful of making a "gift with reservation" when transferring assets. This means gifting an asset whilst retaining a benefit from it. Common examples include gifting:

- **Property but continuing to live in it rent free**
- **Tangible assets (e.g. paintings, cars, antiques) whilst still retaining them**
- **Money whilst receiving the interest**

A gift with reservation is not considered a gift for the purposes of IHT and will therefore be treated as part of the donor's estate when calculating inheritance tax.

3. Trusts

Trusts are a long established route to potentially mitigating IHT. Before we look at the most common types of trust it is worth being familiar with the key parties involved in their creation:

Settlor:	The individual gifting the assets into trust
Beneficiaries:	The individuals receiving the income and/or capital
Life Tenants:	Beneficiaries entitled to the income generated
Remaindermen:	Beneficiaries entitled to the capital
Trustees:	Individual(s) responsible for administering the trust and carrying out the wishes of the settlor

Bare Trusts

These are generally considered the simplest form of trust with beneficiaries receiving an automatic and immediate right to both the capital and interest accrued, typically on the death of the settlor or at the age of 18.

Discretionary Trusts

No beneficiary has an absolute right to income or assets from the trust. Typically, the trust will define a class or classes of beneficiary (e.g. "direct descendants") allowing assets to be distributed over multiple generations.

Contributions to Discretionary Trusts are Chargeable Lifetime Transfers for IHT purposes.

Chargeable Lifetime Transfers (CLT)

A CLT is a transfer that is neither exempt nor potentially exempt and is therefore immediately chargeable. The most common CLT is when an individual settles assets into a discretionary trust. Contributions to a discretionary trust that exceed the available NRB will suffer a 20% CLT charge.

Where the settlor dies within seven years of creating the trust, a further 20% IHT may be payable.

Interest in Possession (IIP) Trusts

An IIP or IPDI (Immediate Post-Death Interest) trust will have two types of beneficiary, a Life Tenant who is entitled to the income generated by investment assets and the Remaindermen who are entitled to the assets of the trust on the death of the Life Tenant. Trust assets should be invested to balance the interests of these two parties.

Trust assets are considered part of the Life Tenant's estate for IHT purposes and can often lead to an unexpected tax bill.

Loan Trust

As the name suggests, a settlor does not gift their assets away with a loan trust which differs from the vast majority of others described. This means there is an element of control as the settlor can recall their loan if they require access to the capital. Whilst this may sound an ideal solution due to the "gift with reservation" rule referenced previously the capital will never actually leave the settlor's estate. Only the growth on trust assets will fall outside of the estate for IHT purposes.

Discounted Gift Trust (DGT)
A DGT offers investors an income (that must be determined at outset) for life and an immediate reduction in the value of the settlement for IHT purposes. The balance of the settlement is considered a PET for IHT purposes, meaning the settlor must survive seven years before the assets will be IHT exempt.

The size of the reduction available will be determined by the level of income drawn and the settlor's life expectancy, with larger reductions available to settlors with a long life expectancy who also draw a high income. Where the income generated remains unspent, it will form part of the estate for IHT purposes.

4. Protection

While the options reviewed so far are designed to reduce the value of the estate for IHT purposes, protection policies are designed to generate funds to pay the IHT bill.

Term Insurance
Term insurance is a pure insurance contract with no investment element. While this is typically cheaper than other insurance options, it does not guarantee a pay out as the term might end before a claim is made. In this instance, the life assured may find it difficult to obtain replacement cover.

Whole of Life Insurance (WoL)
WoL policies overcome some of the issues associated with term assurance as cover is guaranteed for the policyholder's lifetime. The trade-off is higher premiums that, on certain policies, can be reviewed and increase over time.

If an individual takes out a whole of life policy and writes it under trust, beneficiaries should receive a tax-free lump sum. It is not uncommon for individuals to take out life insurance policies to cover the liability due on their estate. Rather than mitigating the liability the payment offsets it.

Whilst insurance based solutions can look appealing, the reality, particularly for older individuals or those in poor health, can be intrusive medicals, the potential for expensive premiums and no guarantee of cover.

EXAMPLE

Mr Moores has an IHT liability of £150k. After considering his options, he elects to insure this liability using a whole of life plan. Mr Moores pays £500pm for the policy meaning, assuming he still holds the policy on death, the plan will generate funds sufficient to pay his IHT bill.

Foresight Highlights

A leading infrastructure and private equity investment manager founded in

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More than **40,000**

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Private equity investment team managing over

£1.3 billion

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£12.2 billion*

of assets under management - energy infrastructure and private equity

GROWTH INVESTOR 2022 | AWARDS — FINALIST BEST BR INVESTMENT MANAGER (UNLISTED)

GROWTH INVESTOR 2021 | AWARDS — FINALIST ESG CHAMPION OF THE YEAR

RUNNER-UP ESG Investing Awards 2021

Correct as at 30 September 2022
*Correct as at 31 March 2023

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- Foresight Guide to **VCTs**
- Foresight Guide to **BR**
- Foresight Guide to **EIS**
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