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How to Avoid Inheritance Tax

By Carl Bayley BSc ACA

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TAX GUIDE – “How to Avoid Inheritance Tax”

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About the Author

Carl Bayley is the author of a series of tax guides designed specifically for the layman. Carl's particular speciality is his ability to take the weird, complex and inexplicable world of taxation and set it out in the kind of clear, straightforward language that taxpayers themselves can understand. As he often says himself, "my job is to translate 'tax' into English".

Carl enjoys his role as a tax author, as he explains: "Writing these guides gives me the opportunity to use the skills and knowledge learned over more than twenty years in the tax profession for the benefit of a wider audience. The most satisfying part of my success as an author is the chance to give the average person the same standard of advice as the 'big guys' at a price which everyone can afford."

Carl takes the same approach when speaking on taxation, a role he frequently undertakes with great enthusiasm, including his highly acclaimed annual 'Budget Breakfast' for the Institute of Chartered Accountants. In addition to being a recognised author and speaker on the subject, Carl has often spoken on taxation on radio and television, including the BBC's 'It's Your Money' programme and BBC Radio 2's Jeremy Vine Show.

Carl began his career as a Chartered Accountant in 1983 with one of the 'Big 4' accountancy firms. After qualifying as a double prize-winner, he immediately began specialising in taxation.

After honing his skills with several major international firms, Carl began the new millennium by launching his own tax and accounting practice, Bayley Miller Limited, through which he provides advice on a wide variety of taxation issues, especially Inheritance Tax planning, property taxation and tax planning for small and medium-sized businesses.

Carl is a member of the governing Council of the Institute of Chartered Accountants in England and Wales and a former Chairman of the Institute Members in Scotland group. He has co-organised the annual Peebles Tax Conference for the last seven years.

When he isn't working, Carl takes on the equally taxing challenges of hill walking and writing poetry and fiction. Carl lives in Scotland with his partner Isabel and has four children.

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Chapter 1

Introduction

1.1 THERE ARE TWO CERTAINTIES IN LIFE

Generally speaking, I find that the oldest sayings are the truest. One old saying is "There are only two certainties in life: Death and Taxes".

At the point where these two great 'certainties' meet lies 'Inheritance Tax', and it is through the medium of this tax that Revenue and Customs will aim to get their final pound of flesh from you, just as you have departed this life.

Most people spend their lifetime trying to accumulate a reasonable amount of wealth, to take care of themselves in their old age and then to pass on any remaining surplus to their children. Much of the Government's fiscal policy is aimed at encouraging this type of behaviour.

It is somewhat unfair then, that without careful planning and a great deal of pre-emptive action, many families will ultimately face a huge Inheritance Tax bill.

Unchecked, this tax bill will rob your family of a significant proportion of their rightful inheritance – up to 40% of it, in fact.

Most people are absolutely appalled at this prospect, which, of course, is where Inheritance Tax planning comes in!

Some years ago, the Labour Party accused the then Conservative Government of allowing Inheritance Tax to become a 'voluntary tax', paid only by the unwary, ill-advised and unprepared taxpayer, whilst wealthier taxpayers took expensive professional advice and avoided the tax.

Certainly, there was an element of truth in this accusation. Furthermore, it remained almost equally true for the best part of another eight years since, despite fears to the contrary, 'New Labour' initially did little to change the Inheritance Tax regime after sweeping into power in 1997.

In 2005, however, it became quite clear that the 'phoney war' was over, when the Government introduced a new Income Tax benefit-in-

kind charge targeted at those families attempting to plan for the inevitable.

That charge, the 'Pre-Owned Assets Charge', is surely one of the worst examples we have ever seen of the Government's well-known tendency to 'use a sledgehammer to crack a nut'. The first payments of this new tax charge fell due in 2007, although I strongly suspect that only a very small proportion of what is technically due is actually being paid.

Not satisfied with getting this quite absurdly Draconian measure on to the statute books, Gordon Brown turned up the heat even further in 2006, with a savage attack on trusts, which I have heard one expert describe as "the most fundamental change to the trust taxation regime in over 20 years".

By this stage, the message from the Government seemed clear: Inheritance Tax was here to stay and it was only going to get worse. Once, the most infamous grave robbers in the land were Burke and Hare; by 2006, we had Brown and Blair!

As far as they were concerned, Inheritance Tax seemed to be a good way to raise extra taxes without losing too many votes. By the usual process of stealth, they seemed intent on steadily increasing the Inheritance Tax take without having to announce any unpopular headline tax increases.

Then, in September 2007, there came the announcement that the Conservatives were proposing a massive increase in the nil rate band exemption to £1,000,000. Suddenly, Inheritance Tax was very much at the centre of the political agenda.

The reaction from the Labour Government was swift and startling. The Pre-Budget Report in October 2007 included a proposal to make nil rate bands transferable between spouses and civil partners with immediate effect.

Suddenly, overnight, it seemed that every married couple, civil partnership, widow, widower and surviving civil partner had effectively doubled their nil rate band. As far as the tabloids were concerned, the war was over: we had won!

Well, if you've read this far, you probably already realise that, in reality, things are not so simple and a great many people still remain exposed to significant potential Inheritance Tax liabilities.

Despite the recent dramatic changes to the Inheritance Tax regime, what remains true to this day is the fact that it is the moderately wealthy members of society who suffer the greatest proportionate burden of Inheritance Tax when compared with their overall wealth.

In my experience, Inheritance Tax is predominantly paid by the modestly wealthy citizens of middle England (as well as middle Scotland, Wales and Northern Ireland too).

The problem for many people in the middle wealth bracket is that they face a fundamental dilemma.

On the one hand they have, on paper, sufficient wealth to leave their family with a very substantial tax burden when they pass away.

On the other hand, however, they do not really have a great deal of disposable income, despite leading reasonably modest lifestyles.

This means that the very simple expedient of just giving all of their surplus wealth away is, in practical terms, simply not an option.

Recent trends have added to this problem. The massive increase in property values from 1997 to 2007 pushed more and more people into the Inheritance Tax bracket, especially in the 'hotspots' like London and the South East and other desirable areas, such as my home town, Edinburgh.

The second factor adding impetus to the 'asset rich/cash poor' situation, which many people now find themselves in, is the current poor level of return on investments.

In short, what this means is that a lot of capital produces only a modest income, leaving a great many people with very little real wealth today but serious Inheritance Tax problems for tomorrow!

In my working life, I see the stress, worry and anxiety that this situation creates on a regular basis. I am firmly of the opinion that the emotional strain which Inheritance Tax places on so many people is so detrimental that it far outweighs any benefits that the Government may derive from collecting the tax.

Personally, I would dearly love to see this immoral and evil tax abolished as soon as possible.

In the meantime, however, I am afraid to say that we seem to be stuck with Inheritance Tax for the foreseeable future, as none of the major

political parties seem prepared to go the whole distance and propose its complete abolition.

In fact, whoever gets into power after the next General Election seems likely to be faced with little option but to raise taxes wherever they can. Inheritance Tax is likely to be a strong candidate and a frozen nil rate band accompanied by an increase in the Inheritance Tax rate are not beyond the bounds of probability.

As ever, there remain two effective ways to avoid Inheritance Tax:

- Die poor, or
- Plan ahead

Most of us find the first option somewhat unpalatable and also quite difficult to achieve without a remarkable sense of timing!

Until recently, 'planning ahead' has also been seen as the prerogative of the very wealthiest members of society, leaving the moderately wealthy to pick up the bill!

However, my aim in this guide is to help put an end to this situation.

If the Government is still prepared to allow Inheritance Tax to be even partly 'voluntary', albeit to a far lesser extent than previously, then why should anyone volunteer?

Early and careful planning is the key to reducing the eventual Inheritance Tax burden on your family and you don't need to be a millionaire to do it. Or to need to do it either, for that matter!

Besides which, a great many people are surprised to discover that when they add up all of their assets they are, in fact, millionaires anyway – on paper, at least.

Whilst some tax can still be saved through 'last-minute' planning, a great deal more unnecessary tax can be avoided by planning for death and taxes throughout your lifetime. Read on and I will show you how.

1.2 GUIDE OVERVIEW

In this opening chapter, we will start by taking a brief look at some background issues important to an understanding of the rest of the guide.

Following that, in Chapter 2, we will cover some of the basics, including how the tax is calculated and who pays it. All of this comes under the general heading of 'know your enemy', because it is important to understand what you're up against before you start to make any plans to combat it.

We then move on, in Chapter 3, to look at the main exemptions which are available at any time, both during your lifetime and on death.

Chapters 4 and 5 look at the area of lifetime transfers, including the additional exemptions available and how to maximise them.

The first five chapters prepare us for Chapter 6, which is devoted to Inheritance Tax planning for married couples, civil partners, widows, widowers and surviving civil partners. This chapter has been completely revised to take account of the changes announced in October 2007.

The changes introduced in October 2007 have fundamentally altered the entire Inheritance Tax planning landscape for all married couples and civil partners. In a great many cases, something which was the best advice before 9th October 2007 is now the very last thing that you should do!

All married couples and civil partners therefore need to consider everything contained in the rest of this guide in the context of the issues and advice set out in Chapter 6.

Chapter 6 also includes a detailed analysis of the position now facing all widows, widowers and surviving civil partners, with advice on crucial tax-saving action which needs to be taken by the recently bereaved.

Even those who are currently single or divorced will benefit from Chapter 6 as it includes vital advice on the potential Inheritance Tax benefits of marriage.

Chapter 7 covers the important area of business property relief, perhaps the most valuable piece of equipment in our Inheritance Tax avoidance armoury.

We will then move into the realm of trusts in Chapters 8 and 9 and we will see what powerful tools these vehicles can provide in the battle against Inheritance Tax.

Chapter 10 reminds us that there is a 'bigger picture' than merely avoiding Inheritance Tax and here we will widen our sights to take in other aspects of estate preservation. This is reinforced in Chapter 11 with a look at the interaction between Inheritance Tax and Capital Gains Tax.

In Chapter 12 we look at the all-important issue of the family home and this will also dominate our review of the pre-owned assets charge in Chapter 13.

In Chapter 14, we cover perhaps the most drastic of all planning techniques, with a guide to emigration, as well as a look at the advantages available to those who have already done it.

Bringing things almost to a close, Chapter 15 provides a useful 'whole life' timetable for effective Inheritance Tax planning, which puts everything else we have learned into context and also reassures us that, whilst it's never too early to start planning, it's never too late either!

Finally, Chapter 16 covers the planning which a bereaved family can still carry out even after someone has died. Whilst this is not the ideal time for truly effective Inheritance Tax planning, it is surprising how much can still be achieved if the deceased's family acts quickly.

This expanded guide, fully updated for all of the drastic changes introduced over the last few years, must surely now have something of value for everyone and provides a useful tool in the battle against the Government's most despicable form of taxation.

1.3 A BRIEF HISTORY OF INHERITANCE TAX

Inheritance Tax, as we know it today, arrived in 1986, the brainchild of Margaret Thatcher and her then Chancellor, Nigel Lawson.

Inheritance Tax is actually little more than a re-branding of its predecessor, Capital Transfer Tax which, in turn, had replaced the earlier and rather more Draconian Estate Duty, which, in its day, had played a major part in turning many of Britain's stately homes into amusement parks!

It is quite ironic that Inheritance Tax should have such a long lineage because it is, of course, one's descendants who will suffer its effects.

The principal difference between Inheritance Tax and its predecessors is the fact that there is a general exemption for most lifetime transfers to other individuals.

This is part of the reason behind the accusations that Inheritance Tax is a voluntary tax, since simply giving all of one's wealth away would initially seem to be an easy way to escape the tax altogether.

However, inevitably, as we will see later in this guide, Inheritance Tax is not quite that easy to avoid. You would have to survive for at least seven years after leaving yourself completely destitute (and homeless), for a start!

1.4 WHY WORRY?

Of course **you** won't actually have to pay any Inheritance Tax on your own estate. Furthermore, for most people, everything can safely be left to their spouse or civil partner free from any Inheritance Tax.

And, if you have no other dependants or potential beneficiaries to care about, but simply resent paying any unnecessary tax, you can simply leave it all to charity.

But most people **do** have someone they care about. Usually they have children or other family or friends whom they want to see benefit from the assets that they have built up in their lifetime and they don't want to see the Government taking 40% of it away.

Even if, in the first instance, you are leaving everything tax free to your surviving spouse, your accumulated wealth will eventually be hit by Inheritance Tax if you don't plan ahead.

As we will see later in the guide, you need to take action **now** in order to safeguard your family's future prosperity.

Alternatively, you may be in the position of being the potential beneficiary yourself, trying to get an elderly relative to plan for the preservation of your inheritance.

Either way, there is plenty to worry about!

But Am I Wealthy Enough to Need to Worry?

Most people are quite surprised to discover just how much they are actually worth. How often have you heard someone say, "I'm worth

more dead than alive". Very often, especially as we get older, it's true. (In pure financial terms only, of course.)

This is basically because it takes an enormous amount of capital just to support one person. When that person dies, the capital that was previously tied up in supporting them is freed. (After the Government gets its share of it, that is!)

Hence, although you may not feel particularly wealthy, you may still find that you have a large potential Inheritance Tax bill.

You'd be amazed at just how many 'paper millionaires' there are these days. Take a look at this example:

Example

Rosemary, a divorcee, owns a fairly average sized detached house, which her ex-husband transferred to her under the terms of their divorce settlement. The house is bigger than she really needs, but her children grew up there, so she is quite attached to it. She has been advised that its current market value is £430,000.

Rosemary is retired and lives off her savings and an investment portfolio that she managed to accumulate after her children grew up. Although these produce an income of only £19,500 per annum, their total value is approximately £535,000. Rosemary also has some jewellery, some silver and a few antiques. Altogether, these are worth £30,000. Lastly, she has a small car, worth £5,000.

Nobody would call Rosemary rich by any stretch of the imagination. She's living off only £19,500 a year. But add it all up and you will find that she is a millionaire! This means that Rosemary's family has a potential Inheritance Tax bill of £270,000!

And you don't need to be anywhere near as 'wealthy' as Rosemary to have an Inheritance Tax problem. Once your estate is worth over £325,000, you have a potential exposure to tax at 40% on the excess (subject to any transferable nil rate band – see Chapter 6).

£325,000! What's that these days? A house, a car and a few savings and you're there!

So, yes, generally speaking, if you can afford to buy this guide there is a strong chance that you are wealthy enough to need to worry about Inheritance Tax!

1.5 WHERE DOES THE TAX COME FROM?

The statistics on the main sources of Inheritance Tax make interesting reading:

- 41% comes from *people's own homes!*
- 26% comes from cash (including savings accounts, deposit accounts, etc.).
- 12% comes from quoted shares and securities.
- The remaining balance comes from household personal effects, insurance proceeds and other land holdings.

The top item on the list is the family home, which proves that this tax is not, as the Government would like to have you think, predominantly raised on the rich.

Admittedly, these statistics do pre-date the changes made in 2007, but it nevertheless remains true that Inheritance Tax is mainly derived from the estates of normal people whose only 'crime' is simply to have been careful with their finances all their life.

We will return to the subject of Inheritance Tax on the family home later in the guide.

1.6 MARRIED COUPLES & CIVIL PARTNERS

Throughout this guide, you will see me refer many times to 'married couples' and 'spouses', as well as to 'widows' and 'widowers'.

Since December 2005, same-sex couples have been able to enter into a civil partnership affording them all of the same legal rights and obligations as a married couple.

This equality of treatment extends to all UK tax law, including Inheritance Tax. In fact, it is probably in the realm of Inheritance Tax that the Civil Partnership Act has provided the greatest tax-saving potential for same-sex couples, putting them, as it does, on a par with heterosexual couples.

Unlike many other countries, the UK has refused to adopt the term 'marriage' for a same-sex couple entering a registered civil partnership. Nevertheless, any references to 'married couples' throughout this guide should be taken to also include civil partners. Similarly, any reference to the taxpayer's 'spouse' will also include their civil partner

where relevant. Equally, when I refer to 'widows' and 'widowers', this will also include a surviving civil partner.

For the avoidance of doubt, I would, in particular, point out that the spouse exemption covered in Section 3.3 and all of the planning issues covered in Chapter 6 apply equally to civil partners.

It is important to remember, however, that unless specified to the contrary, the tax treatment being outlined will be available to legally married couples and same-sex couples in a registered civil partnership only.

1.7 TAX YEARS

Inheritance Tax, like most other UK taxes, is administered by reference to the UK tax year, i.e. the period of twelve months ending on 5th April.

Thus, for example, the 2009/10 tax year is the year ending 5th April 2010.

Any references to the 'tax year' in this guide must therefore be construed accordingly.

Other periods are, however, also important for Inheritance Tax purposes and a reference to a 'period of seven years' or a 'period of more than three years' in this guide, for example, means a strict period of calendar years rather than tax years.

1.8 TRUST TERMINOLOGY

Trust concepts and terminology are key to an understanding of Inheritance Tax planning. As well as the various types of trust, we will encounter important concepts such as 'interest in possession' and 'life interest' throughout this guide.

A full explanation of the trust terminology used throughout this guide will be given in Chapter 8.

1.9 A GUIDE TO EFFECTIVE INHERITANCE TAX PLANNING

All tax planning needs to be undertaken carefully and in full knowledge of all of the particular circumstances of the taxpayer's individual situation.

This is probably never more true than in the case of Inheritance Tax planning, where a detailed review of the individual's situation is vital.

At the present time, the full impact of the 'Pre-Owned Asset Regime' and its resultant Income Tax charges (see Chapter 13) is still not yet fully understood.

On top of this, the full scope of the changes made to the taxation of trusts in 2006 is still being debated. And now, whilst we are still reeling from these major changes, we also have the changes introduced in October 2007.

In this guide, I have dealt with all of the recent changes to Inheritance Tax law on the basis of our current understanding, but it is important to remember that further changes or restrictions could be introduced at any time and the precise meaning of some areas of law will only become apparent when tested in Court: possibly many years from now.

Inheritance Tax law is constantly changing. This means that no one can be sure of having avoided the tax until they are safely tucked up in their grave!

Hence, in addition to taking professional advice when putting your plans into effect, you should also commission a regular professional review to determine whether your planning remains effective.

In this guide, I have highlighted some of the more popular planning techniques currently being used successfully by taxpayers wishing to protect their wealth from the scourge of Inheritance Tax, or which are at least currently believed to work.

Revenue and Customs do, however, have very wide powers to enable them to closely examine any Inheritance Tax planning technique and they will do their utmost to overturn any planning strategy when the law permits them to. The associated operations rules discussed in Section 10.20 are particularly wide-ranging in this regard.

Finally, the reader must also bear in mind the general nature of this guide. Individual circumstances vary and the tax implications of an individual's actions will vary with them. For this reason, it is always vital to get professional advice before undertaking any tax planning or other transactions that may have tax implications. The author cannot accept any responsibility for any loss that may arise as a consequence of any action taken, or any decision to refrain from action taken, as a result of reading this guide.

1.10 ABOUT THE EXAMPLES

This guide is illustrated throughout by a number of examples.

Unless specifically stated to the contrary, all persons described in the examples in this guide are UK resident, ordinarily resident and domiciled for tax purposes.

In preparing the examples in this guide, I have assumed that the UK tax regime will remain unchanged in the future except to the extent of any announcements already made at the time of publication.

However, if there is one thing we can predict with any certainty, it is that change **will** occur. The reader must bear this in mind when reviewing the results of our examples.

All persons described in the examples in this guide are entirely fictional characters created specifically for the purposes of this guide. Any similarities to actual persons, living or dead, or to fictional characters created by any other author, are entirely coincidental.

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