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How to Save Inheritance Tax

By Carl Bayley BSc FCA

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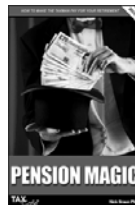
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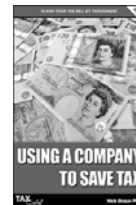
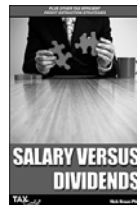
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About the Author

Carl Bayley is the author of a series of 'Plain English' tax guides designed to help families, landlords, and other business owners understand the taxes they face and make savings through sensible planning and by having the confidence to know what they are entitled to claim. 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 thirty 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.

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Carl is the Chairman of the Tax Faculty of the Institute of Chartered Accountants in England and Wales and a member of the Institute's governing Council. He is also a former President of ICAEW Scotland and has co-organised the annual Practical Tax Conference for the last 16 years.

When he isn't working, Carl takes on the equally taxing challenges of hill walking and creative writing – his Munro tally is now 104, and he is currently putting the finishing touches to his first novel.

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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 the Government will aim to get its 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 previous 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, and in fact still is, an element of truth in this accusation.

In recent years, however, it has become increasingly difficult to avoid this hated 'grave-robbert's tax', with a host of measures introduced by Governments of all persuasions designed to block many of the popular methods used by families attempting to plan for the inevitable.

As we will see later in the guide, some Government attempts to block Inheritance Tax planning suffer from their well-known tendency to 'use a sledgehammer to crack a nut'. In fact, the scope of one particular charge (the 'Pre-Owned Assets Charge') is so wide that many innocent taxpayers are completely unaware that simple domestic arrangements like buying a house together may have led to a charge being technically due.

Not satisfied with getting this quite absurdly Draconian measure on the statute books, Gordon Brown turned up the heat even further in 2006, with a savage attack on trusts.

Help seemed to be at hand the following year when the Conservatives proposed a massive increase in the nil rate band exemption to £1m. Although this did not materialise for many years and, even then, it had been watered down beyond all recognition by a host of 'ifs', 'buts' and 'maybes', it did at least prompt the old Labour Government into making nil rate bands transferable between spouses and civil partners.

Suddenly, overnight, it seemed that almost every married couple, civil partnership, widow, widower and surviving civil partner had effectively doubled their nil rate band.

Since then, however, things have taken a turn for the worse: as it seems that all our politicians are happy to break their promises when it comes to Inheritance Tax.

Alistair Darling kicked off the 'season of broken promises' in 2009 when he announced that the planned increase in the nil rate band set for the following year would not go ahead. Worse still, he went on to announce a five year freeze in the nil rate band at its 2009 level of £325,000.

Soon afterwards, Labour were ousted and the Conservatives became the 'senior partner' in the first post-war Coalition Government. Sadly, however, their promised increase in the nil rate band was swiftly shelved and Labour's five year freeze retained instead: later extended to eight years; and then to twelve!

So, despite our change of Government, we are now stuck with a nil rate band of just £325,000 until at least 2021.

At the time of writing, we are nine years into the twelve year freeze period and inflation has already severely eroded the value of the nil rate band. A bout of high inflation before 2021 would reduce its value even further and could undo most of the benefit of the transferable nil rate band regime introduced in 2007 (and those who are single or divorced never even had that benefit in the first place).

Make no mistake about it; the twelve year freeze in the nil rate band is a significant tax-raising measure. As the value of the band decreases in real terms due to inflation, the Government's Inheritance Tax take is steadily increasing.

On top of all the broken promises about the nil rate band, the 2013 Budget brought yet more misery, as George Osborne announced a raft of new rules to restrict the deduction of liabilities for Inheritance Tax purposes.

As one might expect, the rules restricting the deduction of liabilities will block a number of popular planning techniques. However, what will be less apparent to most people is that the rules will also lead to some astonishingly unfair results, especially when a family business or family farm is passed on to the next generation.

We will look at the impact of these rules in more detail later in the guide, but it is clear to me that they severely undermine the original intention of helping small and medium-sized businesses to survive their owner's death. The additional Inheritance Tax burden which will now be placed on many families as a result of these new rules will inevitably reduce many businesses' chances of survival.

In the July 2015 'Summer Budget', Osborne finally returned to that promise of a £1m nil rate band. And what a mess he made of it!

Instead of the simple £1m nil rate band that he had originally promised in 2007, he created a new, additional, 'residence nil rate band', which is only available under certain very restricted circumstances: as we shall see later in the guide.

Claiming that the new residence nil rate band amounted to the equivalent of a £1m nil rate band: "Promise Made, Promise Delivered!", as he said; was somewhat disingenuous since, to get the required level of exemption, necessitates a complex combination of circumstances.

What Osborne did was rather like me promising to give one of my children £1,000 tomorrow – no strings attached, to do with as they please; but, instead of doing as I said, waiting eight years and then telling them that I would give them £1,000 in another five years' time, but only if they got married and bought a house.

That's what I call: "Promise Made, Promise Broken".

Despite all the changes to the Inheritance Tax regime over the last few years, what still remains true to this day is the fact that it is the moderately wealthy members of society who suffer the greatest proportionate burden when compared with their overall wealth. In fact, it seems to me that the new restrictions on deduction of liabilities are likely to further exacerbate this tendency.

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 their surplus wealth away is, in practical terms, simply not an option.

Recent trends have added to this problem. Massive increases in property values in some parts of the country have 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 Edinburgh or Bath.

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, evil tax abolished as soon as possible.

Sadly, however, I am afraid to say that, in reality, we seem to be stuck with Inheritance Tax for the foreseeable future: as all of the major political parties now seem quite happy to play the role of 'grave robber' and at least two of them are content to abandon any promises they may have made in the past.

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; as well as those which are only available 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.

The changes introduced in 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 2007 is now the very last thing 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 planning 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 saving 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. Here we will take a detailed look at some of the practical implications of the new residence nil rate band, as well as some of the other planning techniques available to shelter the family home from the Government's most despicable form of taxation.

The family home will then 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 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 is a divorcee with no children of her own: although she is very close to her two younger sisters and their children. She 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 she has fond memories of the many holidays her nephews and nieces spent there, so she is quite attached to it. She has been advised that its current market value is £450,000.

Rosemary is retired and lives off her savings and an investment portfolio that she managed to accumulate after her divorce. 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 £10,000. 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; and any available residence nil rate band: see Section 3.4).

£325,000! What's that these days? A house, a car, 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 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'. In each case, the tax treatment being outlined applies equally to:

- Married couples of opposite sexes,
- Married couples of the same sex, and
- Registered civil partners

Hence, any references to 'married couples' throughout this guide should be taken to also include registered civil partnerships; any reference to the taxpayer's 'spouse' will also include their civil partner where relevant; and any reference to 'husbands' or 'wives' will include spouses of the same gender and civil partners. Similarly, any reference to 'widows' or 'widowers' will include surviving spouses or civil partners of the same sex.

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 same sex spouses and civil partners.

However, it remains important to remember that, unless specified to the contrary, the tax treatment being outlined applies to legally married couples and legally registered civil partners only.

1.6 TAX YEARS

Inheritance Tax, like many 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 2018/19 tax year is the year ending 5th April 2019. Any references to the 'tax year' in this guide should be construed accordingly.

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

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

1.8 PROPERTY TAXES

Inheritance Tax planning often involves the transfer of UK property. This will sometimes lead to tax charges arising on the transfer in the form of some variation of Stamp Duty. The type of Duty arising will depend on which part of the UK the property is located in, as follows:

England:	Stamp Duty Land Tax
Scotland:	Land and Buildings Transaction Tax
Wales:	Transfers before 1st April 2018: Stamp Duty Land Tax Transfers on or after 1st April 2018: Land Transaction Tax
Northern Ireland:	Stamp Duty Land Tax

The rules applying under each form of Duty are broadly similar. There are some variations in the rates applying, but these are fairly minor. Full details of the rates applying to all UK property are included in the Taxcafe.co.uk guide '*How to Save Property Tax*'.

For the sake of simplicity, I will refer only to Stamp Duty Land Tax, or 'SDLT', throughout the rest of this guide, but readers should note that similar charges will arise on property in Scotland or, from 1st April 2018, Wales: except that the Duty will have a different name and will be charged at slightly different rates.

1.9 A GUIDE TO EFFECTIVE INHERITANCE TAX PLANNING

All tax planning needs to be undertaken carefully and in full knowledge 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.

I have dealt with all of the recent changes to Inheritance Tax law on the basis of our current understanding. 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 no one can be sure of having avoided the tax until they are safely tucked up in their grave! 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.

HMRC does, however, have very wide powers to enable it to closely examine any Inheritance Tax planning technique and will do its utmost to overturn any planning strategy when the law permits it to.

The associated operations rules discussed in Section 10.21 and the general anti-abuse rule covered in Section 10.22 are both 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 and Taxcafe UK Ltd 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 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 the 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.

1.11 ABBREVIATIONS

Generally, at Taxcafe, we don't like using abbreviations or jargon because we want to keep our guides as simple as possible. To save some space in this guide, however, we have allowed ourselves a few abbreviations. We think they are fairly obvious ones, so they should not cause any confusion. We will explain what each abbreviation means the first time that we use it and they are also set out again in Appendix I for your ease of reference.

Large numbers, such as £1,000,000 or more, are also abbreviated by use of the letter 'm'. For example, £2,500,000 will be written as £2.5m

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