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John Humphreys, Inheritance Tax Specialist at WAY Investment Services

Inheritance Tax – what lies beneath the surface

Understanding clients' objectives is always crucial for successful financial planning. For many people, preserving at least some of their family's wealth so that it can be passed on to the next generation may well be on the list of wishes. If this is an objective, no plans can be made without considering Inheritance tax (IHT). As with any form of tax, how it works in practice is rarely as simple as the headline rate. Likewise, some of the headline-friendly strategies to deal with the tax rather resemble icebergs, with a whole host of knock-on effects lurking beneath. Advisers and Paraplanners need to make sure they are well informed not just of the headlines, but also the further impacts hidden below the surface.

The Residence Nil Rate Band (RNRB) is a prime example. Announced on 8th July 2015 and implemented with effect from 6th April 2017, its headline-friendly concept may well appeal to families who have benefitted from growth in the value of their property. The trouble is, introducing a new nil rate band rather than just increasing the existing one also introduced a whole new set of rules. As ever, the devil is in the detail. Unlike the basic IHT threshold, the RNRB can only be applied to property being passed on to direct descendants. A person who has nephews and nieces, but no children, could therefore leave a larger IHT liability than someone who also has no children but leaves their estate to their step-child.

The rules around downsizing are also complicated. The RNRB can also apply to assets of an equivalent value if someone downsized or sold a property on or after 8th July 2015, and personal representatives can nominate which property that is. Clear records will be essential. Although introduced to make it easier to pass on the family home, it can therefore be used, possibly, to pass on the proceeds of a family home, depending on where those now are. Unlike the basic NRB, there is also tapered withdrawal of the RNRB relief for estates worth more than £2 million. Simple it most certainly isn't. The Government recently held a consultation on trust taxation, including discussion of IHT as it applies to trusts. WAY's view is that the RNRB is neither fair nor simple, and that it should be repealed, with the same incremental increases being absorbed into the NRB, which would help it to be restored to a level appropriate to reverse the loss of its real value over the last 10 years. In the meantime, advice teams need to know how it works and how it applies today.

An often-cited, headline-friendly relief is Business Property Relief (BPR) – whereby certain investments, including some on the AIM market, potentially qualify for IHT relief. But it's crucial not to miss the word *potential*. In order to qualify, such investments need to have been held continuously for a minimum of two years at the point of a person's death, and the exemption will only ever be confirmed following assessment by HMRC after death. There are umpteen reasons why any particular investment taken out by a person in say, middle age, may not be held by that person at their death, with even more reasons where the investment is a high-risk AIM stock. But if such investments are taken out for the purposes of IHT planning, they would need to be held effectively indefinitely (or at least until the end of the person's life), in order for the IHT exemption to be realised..

In addition, unlike gifts into trust, BPR-qualifying investments are *not* outside a person's estate for Residence Nil-Rate Band (RNRB) purposes which means that an estate may not then be eligible to claim the RNRB. Another knock-on effect hiding beneath the surface is that this could push an estate into a higher bracket for the recently-announced hike to probate fees. This can be demonstrated by an example of two estates, choosing different strategies to plan for IHT:

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	Family A	Family B
Starting value of estate	**£2.7 million**	**£2.7 million**
Value of IHT exempt investments/gifts on death of widow/widower	£700,000 BPR investment (invested at least 2 years before death)	£700,000 (2 x NRBs gifted to discretionary trust at least 7 years before death)
Remaining estate	Main residence £1 million Other assets £1 million	Main residence £1 million Other assets £1 million
Gross estate value of estate for probate calculation	£2.7 million	£2 million
Probate fee due **(Proposed fees due to be introduced from 6th April 2019)**	**£6,000**	**£5,000**
Net estate subject to inheritance tax	£2 million	£2 million
Exemptions applying:	NRB £325,000 x 2 = £650,000 *RNRB doesn't apply because at £2.7 million the gross estate is above the upper taper threshold*	NRB £325,000 x2 = £650,000 RNRB £150,000 x 2 = £300,000
Net estate after reliefs and exemptions deducted	£1.35 million	£1.05 million
Inheritance tax due (40% of net estate after reliefs and exemptions deducted)	**£540,000**	**£420,000**

Notes:
NRB: *Nil Rate Band set at £325,000 until the end of the 2020-21 tax year*
RNRB: *Residence Nil Rate Band set at £150,000 for the 2019-20 tax year*

For Family B, the trustees can immediately loan or appoint funds to the Beneficiaries to pay the probate bill plus any associated legal costs, and the IHT bill. Family A would have to find other means to pay the probate and legal bills, as well as their IHT bill, which is £120,000 higher as a result of losing the RNRB.

Inheritance tax can and should be planned for – so that families understand their future tax liabilities and have the means in place to pay it, preferably without needing to wait for probate. Advice teams need to ensure they have addressed some key questions. What is the Inheritance Tax liability today and likely to be in the future? What exemptions are available, are they being used, and with what level of certainty? Are the means in place to pay for probate? Well-thought out plans, made in good time, can ensure families are prepared and their objectives are met.

WAY Investment Services,
Cedar House, 3 Cedar Park, Cobham Road, Wimborne, BH21 7SB
Telephone 01202 890895
www.wayinvestments.co.uk