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A guide to inheritance tax

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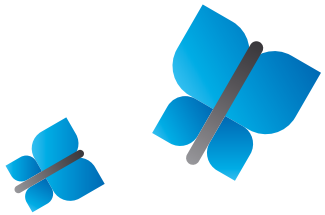


For UK Investors only

This Guide to Inheritance Tax is an overview only and should not be interpreted as constituting tax or investment advice.Tax treatment depends on the individual circumstances of each investor and may be subject to change.

Investors should always seek independent investment and tax advice before investing.

1. Understanding inheritance tax

In its simplest terms, inheritance tax is a tax on the money or assets that a person leaves behind when they die. It can also apply to some gifts that are made before someone dies.

When an individual dies, the property, money and other assets that they leave behind (minus any debts that have to be paid off) is known as their 'estate'. This estate is usually left to the friends and family of the person who has died and effectively becomes their inheritance. This is where inheritance tax (or IHT for short) comes in. Thanks to IHT the UK government is able to lay claim to a sizeable chunk of the value of an individual's estate when he or she dies.

Of course, IHT is a tax that not everyone is required to pay. It's only due if the deceased's estate is valued over the current IHT threshold (£325,000 until 2018). The tax is payable at 40%* on the amount over this threshold. If the estate is valued below this threshold it falls within the nil rate band (NRB) and no IHT is payable. What this means is that an individual with an estate worth more than £325,000 will be required to pay IHT at a rate of 40% on anything above that level.

Did you know?

IHT in its current format was introduced in 1986, although in the UK the first recorded tax on a deceased person's estate can be traced as far back as 1894.

WHAT ABOUT MARRIED COUPLES?

Married couples and civil partners are able to pass their assets and possessions to each other tax-free on death. Also, if the tax-free allowance is not used by the first to die, the surviving partner is then able to double the nil rate band to £650,000 upon their death.

So an example would be:

John Smith dies leaving an estate (home and investments)	= **£500,000**	
Subtracting the NRB means £500,000–£325,000	= **£175,000**	(John Smith's taxable estate)
John Smith's estate will be taxed at a rate of 40%*	= **£70,000 IHT bill**	(i.e. £175,000 x 40%)

* Since April 2012 the rate of IHT payable is reduced to 36% provided the deceased leaves 10% or more of their estate to charity.

2. Should I be worried about inheritance tax?

Anyone thinking that IHT is just a headache for the seriously wealthy needs to think again. Every year, an increasing number of people are affected by IHT.

According to the Office for Budgetary Responsibility, more than £3.5 billion of inheritance tax was collected by HM Revenue & Customs in the 2013/14 tax year. This is a staggeringly high amount, especially considering that IHT is one of the few taxes that people can legitimately avoid paying by planning ahead. Remember, every pound paid in IHT means a reduced estate for the deceased's loved ones.

IHT might originally have been intended to help redistribute wealth from the rich back to the state, but now the NRB threshold, which affects who pays IHT, seems a little on the low side. According to the Land Registry of England and Wales, the average house price in the UK is £250,000, but in Greater London that average swells to more than £450,000. So, it's easy to see how a large number of people will find the value of their estate extending beyond the NRB threshold simply because their home has increased in value in recent years.

To see if your estate will be liable to IHT when you die, add up the value of everything you own in your name, or a share of anything owned jointly, including:

- ✓ Your house and any other properties you own
- ✓ Any savings or investments
- ✓ Other assets from which you receive an income
- ✓ The value of any life insurance policies in your name

Now deduct any debts, such as outstanding mortgage or loan, and anything you want to leave to charity. You can also deduct the value of any gifts made on death that are exempt from IHT (there are strict rules in place that govern whether gifts are exempt – you can read more about this on page 7) and the reasonable costs of your funeral.

Did you know?

A survey carried out by unbiased.co.uk found that IHT is the second most resented tax amongst the British public, beaten only by council tax.

2. Should I be worried about inheritance tax? (continued)

YOUR MARITAL STATUS AFFECTS YOUR IHT LIABILITY

Marital status	
Single	Up to 40% IHT is due on the value of your estate over £325,000.
Married / civil partnership	Any of your estate to be passed onto your spouse or civil partner will be transferred tax free*. Up to 40% IHT is due on the value of your estate over £325,000 that is passed on to anybody other than your spouse or civil partner. Your surviving spouse or civil partner, now widowed, is then subject to IHT as outlined below.
Widowed	The tax-free amount available on your death depends on what your spouse or civil partner left people other than to you when they died. If they passed on an estate worth MORE than £325,000 to anyone other than you, you WILL NOT benefit from their NRB. Therefore up to 40% IHT is due on the value of your estate over £325,000 (i.e. your NRB) when you die. If they left you everything and have not made any gifts during their lifetime they have not used any of their NRB, meaning you can combine theirs with your own. This means up to 40% IHT would be due on the value of your estate over £650,000 (i.e. the value of your combined NRBs).
Unmarried	You are treated as single for IHT purposes. Laws in Scotland give unmarried couples some rights to each other's property on death or separation, but do not affect the IHT rules. The Law Commission has suggested similar changes in the law for unmarried couples in England and Wales but again, these will not change the rules on IHT.

* 58% of UK adults don't have a will (Source: Unbiased.co.uk, 2013). For married couples and civil partnerships, a will can have a huge impact on your IHT liability. You can find out more about wills in our guide to writing a will, which is available online.

3. Inheritance tax planning

People who don't consider IHT planning before they die could be storing up problems for the loved ones they leave behind.

WHO PAYS THE IHT BILL AND WHEN?

An individual's IHT liability is usually paid from their estate, so whatever is left over after all debts have been paid. In most cases, IHT must be paid within six months from the end of the month in which the death occurs. If not, interest is charged on the unpaid amount. Tax on some assets, including land and buildings, can be deferred and paid to HM Revenue & Customs in instalments over ten years. However, if the asset is sold before all the instalments have been paid, the outstanding amount must be paid in full.

If IHT is due on gifts made by the deceased in the last seven years before their death, those people who received the gifts must repay any IHT due. If they cannot or will not pay, the amount due then comes out of the deceased's estate. There are strict rules in place that govern whether gifts are exempt – you can read more about this on page 7.

LEAVING ASSETS TO A SPOUSE OR CIVIL PARTNER

When it comes to IHT planning, the easiest option is to leave assets in your will to your spouse or civil partner. As a result, your spouse or civil partner will not have to face selling your home to pay for the tax and will have a double NRB allowance (worth up to £650,000) when they die. Also, any gifts between spouses or civil partners are exempt from IHT, whether they were made while both parties were still living, or if they were left to the surviving spouse or civil partner upon death.

THE IMPORTANCE OF MAKING A WILL

Failing to leave a will when you die (known as dying 'intestate') can put a lot of stress and strain on the people left behind and your estate may not be passed on in line with your wishes. This is of particular concern for couples who are not married or not in a civil partnership. If you have no close relatives and die intestate then the government can end up with your assets. It's therefore crucial to make a will, even if you want to ensure that your estate is left to your favourite charity. You can find out more about wills in our Guide to Writing a Will that is available online, or speak to your financial adviser.

TWO DEATHS IN FIVE YEARS

If someone dies within five years of inheriting property from an estate where IHT was due, the tax due on their death can be reduced. There is a rather complicated sliding scale of successive charges relief (or sometimes called 'quick succession relief') but it only applies if IHT has been paid. Seek advice from your solicitor and your financial adviser if you think this applies to you.

3. Inheritance tax planning (continued)

GETTING HELP WITH IHT PLANNING

The good news is that, with the right financial planning, practically everyone with an IHT liability should be able to reduce or eliminate it, and pass on as much of their estate to their loved ones as possible. There are a number of different IHT planning solutions available, suiting a wide variety of people. Finding the right approach will depend on your individual circumstances and talking to a qualified investment adviser will help as they can explain the different options available.

WHERE TO GET HELP AND ADVICE

Planning what assets to leave, and to whom, can be complicated, so it's important to get professional advice from a solicitor, tax adviser or independent financial adviser. There is some useful basic information on the HM Revenue and Customs website: www.hmrc.gov.uk

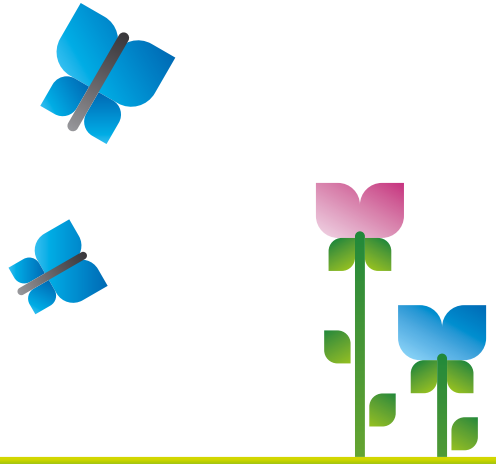
Did you know?

To write a legally binding will you need to be:

- ✓ At least 18 years old,
- ✓ A UK resident,
- ✓ Of 'sound mind', i.e. you can understand the consequences of what you're doing

"In this world nothing can be said to be certain, except death and taxes."

Benjamin Franklin, 1789



4. Using gifts

One way to lessen a potential IHT bill is to simply 'gift' your assets away. However, there are some pitfalls that you need to be wary of.

HM Revenue & Customs allows individuals to gift up to a total value of £3,000 a year (known as the annual exemption). If you do not use your £3,000 total in one year you can 'carry over' the remainder and add it to the next year's annual exemption, although you can only do this for one year.

Individuals can make as many small gifts as they wish, as long as the total given to any one person is no more than £250 in any one year. You cannot use your annual exemption and your small gift exemption on the same person in any one year.

GIFTS TO FAMILY

Any gifts between spouses or civil partners are free from IHT. HM Revenue & Customs also allows individuals to make wedding gifts free of IHT, up to a limit of £5,000 for each son or daughter, £2,500 for each grandchild and £1,000 for anyone else. Gifts made to children who are not relatives remain exempt as long as they are in full-time education. Regular gifts from after-tax income, such as a monthly payment to a family member, are also exempt as long as the giver still has sufficient income to maintain their standard of living.

IHT will not be paid on gifts made to charities, national museums, universities, the National Trust, political parties and some other institutions such as housing associations.

Any assets that you give away will fall outside of your taxable estate seven years after the gift was made. However, if a person dies within this seven year period, the full value of the gifts will still be included in the final IHT bill. It's worth noting that the rate of IHT due reduces if the donor survives between three and seven years (this is know as taper relief).

DO I NEED TO KEEP RECORDS OF GIFTS?

Although there is no formal obligation to keep records of gifts that you make while you are alive (whether they are IHT exempt or not), the executors of your estate are obliged to discover them all and to make sure the correct IHT is paid. So, it would be very helpful to your executors – who will normally be your heirs – to keep a note of any gifts that you make. If you think they are exempt gifts then explain why. Keep these documents with your will or other papers so that they are easily found.

Another good reason to keep detailed records is that everything that makes up the estate left by a spouse or civil partner will be taken into account when calculating the allowance on the second spouse's or civil partner's estate.

Remember

YOU don't pay IHT. It is paid out of your estate and therefore has the potential to drastically reduce the value of the assets you pass on to your loved ones when you die.

5. Using trusts

People use trusts to help ensure that assets can be given to beneficiaries but in a timely and controlled manner, and without incurring an IHT bill.

WHY USE A TRUST?

A trust can be used by someone who wants to make a gift to a third party (known as the beneficiary). For example, many people set up trusts so that part of their estate goes directly to their grandchildren when they die. The trust can be designed to make sure that assets remain in place until the beneficiaries reach a certain age, usually 18 or older. There are several different types of trust available, some examples are below.

BARE TRUSTS, OR ABSOLUTE TRUSTS

With a bare trust, the beneficiaries are entitled to all of the assets that are held within the trust. The main duty of the trustees (the people appointed to manage the trust) is to manage the assets for the beneficiaries and to transfer the assets when required.

INTEREST IN POSSESSION TRUSTS

An interest in possession trust is one where the beneficiary of a trust has an immediate and automatic right to the income from the trust as it arises. The trustees must pass all of the income received, less any trustees' expenses, to the beneficiary. The beneficiary who receives the income often doesn't have any rights over the capital of such a trust. Instead the capital will normally pass to a different beneficiary or beneficiaries in the future.

DISCRETIONARY TRUSTS

In a discretionary trust, the trustees are the legal owners of any assets held in the trust. They are responsible for running the trust for the benefit of the beneficiaries, with 'discretion' about how to use the trust's income and capital. A discretionary trust may be set up to provide money for a future need that is not yet known - grandchildren, for example.

DISCOUNTED GIFT TRUSTS

A discounted gift trust is a discretionary trust arrangement that is usually set up to look after an investment. It allows an individual to 'gift' a lump sum into a trust but lets them keep the income paid out by the investment, usually for the rest of their life. A discounted gift trust is a powerful planning tool for someone who wants to ensure an investment wont be liable to IHT, but where they still need access to the income from the investment itself.

Remember

Most trusts are arranged through a solicitor as the trust rules are constantly reviewed and can be complex.

6. Equity release

Some people with most of their wealth tied up in property consider making use of an equity release scheme to provide an income, especially during retirement.

Equity release schemes allow homeowners to borrow money against the value of their property, either through a lifetime mortgage or as part of a scheme where they sell a percentage of the property but continue living there for the rest of their lifetime.

These schemes can be used as part of IHT planning because the money released can be passed on to beneficiaries and providing the individual survives the gift by seven years, there will be no IHT to pay. However, both of these schemes directly reduce the value of the deceased's estate.

Equity releases are suitable for some people but they also carry risks which must be considered. A lifetime mortgage will mean taking on additional debt which may not be right for the individual and which could cancel out any IHT savings. Selling a percentage of the property can also carry risk and may not offer good value for money.

If you think equity release might be for you, you shouldn't rush to make the decision. Make sure you talk to your heir(s) and make sure you consult an independent financial adviser who specialises in equity release before going ahead.

Rules introduced in April 2013 mean that where a loan, mortgage or equity release scheme is used to finance an IHT-exempt investment, the debt won't be treated as reducing the value of the investor's estate for IHT purposes when they die.

7. Using business property relief (BPR)

Business property relief (BPR) can be a valuable relief from IHT. It allows you to claim relief on business assets that you own, including qualifying businesses that you hold shares in.

BPR: THE BASICS

BPR was introduced as part of the 1976 Finance Act, and was created to allow small businesses to be passed down through generations without incurring an IHT liability. However, over the years the scope of BPR has been widened, making it an attractive option for individuals looking to invest in companies in order to remove a potential IHT burden.

WHICH COMPANIES QUALIFY FOR BPR?

- ✓ Smaller companies that are not listed on the main London Stock Exchange
- ✓ Some companies that are listed on the Alternative Investment Market (AIM) or Plus stock exchanges
- ✓ Businesses considered to be 'actively trading', and are therefore not just investment companies

It is worth noting that some businesses, including those that deal in stocks and shares, land or buildings and some specific industries (including resources and mining companies and also not-for-profit organisations) do not qualify for BPR.

INVESTMENTS THAT USE BPR

Some investment companies offer products that invest in companies that qualify for BPR, for example AIM-listed or unquoted companies. This means that the investment itself, as long as it is held for two years, will not be subject to IHT upon the investor's death. Married couples and civil partners also have the option to transfer the investment between spouses or civil partners. This means that should the investor die during the initial two year period, the investment can be transferred to their surviving spouse or civil partner without resetting the two year clock.

There are a number of rules relating to products that invest in BPR qualifying companies, including that the investment company must invest your money and hold qualifying assets for two years to qualify. They must replace any companies sold from the portfolio within three years, and the assets (and therefore the investment) must be held at time of death for the investor to get IHT relief. Using BPR effectively within investment products is a complicated business, so if you decide this is the right option for you, it's important to choose a company that's experienced in investing in this area. The benefits of BPR for investors are outlined on the next page.

7. Using business property relief (BPR) (continued)

WHAT ARE THE BENEFITS OF BPR?

Faster IHT exemption:
Unlike gifts and trusts, which generally take seven years before they're fully exempt from IHT, BPR-qualifying investments are IHT exempt after just two years (provided the investments are held at the time of death).

Greater access and control:
Unlike with a gift, the investor retains control over the investment, and can get their money back, if they need to. However, money taken out of the investment may not be shielded from IHT.

Income options:
Many BPR solutions allow the investor to take an income from their investment.

Simplicity:
BPR investments are relatively simple and straightforward to invest into. Generally there are no complex legal structures, and there may not be a requirement for client underwriting or medical surveys.

KEY RISKS

There are risks to investing in BPR based Solutions. These include:

- Your capital will be at risk and you may get back less than you invest
- Tax rules relate to the individual and could change
- Tax reliefs depend on investee companies maintaining their qualifying status
- Investments in AIM listed and unquoted companies are likely to have higher volatility and liquidity risk than shares quoted on the London Stock Exchange Official List.

Before making a decision to invest in a BPR solution you should speak to a financial adviser and refer to the relevant product literature for full details of the risks to makesure you're comfortable with them.

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