Inheritance tax planning: a pragmatic approach

Inheritance tax and trusts



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Some clients may find inheritance tax planning uncomfortable, but it is crucial to develop a tailored plan that aligns with their goals and circumstances.

Key Points

What is the issue?

A combination of long-stagnant thresholds and ever-rising property values has meant that more individuals are now finding themselves pulled into the inheritance tax net, highlighting the importance of proactive planning.

What does it mean for me?

There are four primary strategies which can be balanced for managing inheritance tax liabilities, though each will of course be tailored to individual circumstances.

What can I take away?

When planning for inheritance tax, it is essential to adopt a pragmatic mindset that prioritises both long-term financial sustainability and the wellbeing of beneficiaries.

The topic of inheritance tax is often clouded in ambiguity and apprehension. Aside from discussions around death and inheritance still being considered uncomfortable or even taboo for many families, there are myriad regulations, exemptions and reliefs to navigate. This emotional and regulatory complexity is even more reason to adopt a pragmatic approach when managing estates. This involves not only understanding the tax implications but also crafting a comprehensive plan that maximises the benefit for both the estate holder and their beneficiaries.

One of the fundamental aspects of navigating inheritance tax is being aware of the regulations in place. In the United Kingdom, inheritance tax is levied at a rate of 40% on the value of an estate above a certain threshold (the nil rate band), which currently stands at £325,000. There is a further £175,000 allowance (the residence nil rate band) where the estate holder leaves their main residence to children or grandchildren and the total estate is worth less than £2 million. A combination of long-stagnant thresholds and ever-rising property values – given that for many, the majority of estate value derives from property – has meant that more individuals are now finding themselves pulled into this tax net, highlighting the importance of proactive planning.

Four primary strategies

The introduction of pre-owned assets tax in 2005 and the changes to trust taxation in 2006 changed the historic landscape on inheritance tax planning, removing the use of tax schemes and reducing the effectiveness of trust planning.

As a consequence, there are four primary strategies which can be balanced for managing inheritance tax liabilities, though each will of course be tailored to individual circumstances.

1. Keep assets and pay the tax

Some individuals prefer to retain their assets, accepting the tax liabilities as a natural consequence. This approach suits those who prioritise maintaining control over their wealth and those who don’t have strong intentions to pass on significant assets or who don’t have dependents.

2. Insurance

For those concerned about leaving behind a substantial tax burden or having a reticence over making gifts, insurance can serve as a viable strategy. This is particularly the case if the family home forms the majority of the estate.

Insurance policies can provide a tax-free lump sum payout upon death, by ensuring that the beneficiaries receive sufficient funds to settle any inheritance tax liabilities without depleting the estate. Whole of life insurance is most usual for inheritance tax provision as the payout is certain and can be guaranteed. It is expensive, as it acts both as a savings plan and as life assurance. Term assurance can, however, also form part of a strategy as a temporary mechanism whilst developing a strategy particularly to protect against an unexpectedly early death.

3. Spend it

Individuals can also choose to spend their assets on themselves during their lifetime, whether it’s on travel, hobbies, medical expenses or other expenditures, rather than leaving them to be taxed upon death. By reducing the value of their estate through spending, they can reduce the amount subject to inheritance tax. For individuals who have spent their working life saving for their retirement, it is important that they do also focus on enjoying the fruits of the labour.

4. Succession plan

Succession planning involves strategically gifting assets during one’s lifetime to gradually reduce the value of the estate. By leveraging exemptions and reliefs, individuals can gradually diminish their estate size while minimising tax exposure.

Key reliefs

One significant relief is the potentially exempt transfer (PET), which allows individuals to gift assets during their lifetime. If the donor survives seven years after making the gift, it falls outside of their estate for tax purposes. However, if the donor passes away within the seven-year period, the gift may still be subject to inheritance tax, albeit with tapering reducing the burden on a sliding scale.

Another key relief is normal expenditure out of income. This allows individuals to gift assets as part of their regular spending habits, provided it does not significantly impact their standard of living. This strategy is particularly useful for individuals with surplus income who wish to pass wealth onto their beneficiaries gradually.

One common strategy is to make use of annual gifting allowances, such as the £3,000 annual exemption for gifts. Additionally, individuals can take advantage of small gifts exemptions, allowing them to gift up to £250 per person to any number of individuals per year without incurring inheritance tax.

Inheritance tax planning

Working closely with tax and financial advisers is paramount in developing a tailored plan that aligns with an individual’s goals and circumstances. Advisers can help clients to assess their assets, expenditure requirements and long-term financial objectives to devise a comprehensive inheritance tax strategy. By taking into account factors such as age, health and family dynamics, advisers can tailor solutions that not only minimise inheritance tax but also ensure financial security for the individual and their beneficiaries.

A critical aspect of inheritance tax planning is striking a balance between meeting one’s own income requirements and reducing tax liabilities. With people living increasingly longer lives, it might be a mistake to prematurely ‘give it all away’, only to find that one’s lifestyle suffers in the later years of their life as a result.

Advisers can play a crucial role in assessing individuals’ current and anticipated future income needs. This includes considering factors such as living expenses, healthcare costs and potential long-term care expenses. An understanding of short-term and long-term financial requirements and cashflow planning informs better decisions about how much wealth can be feasibly transferred while maintaining the desired standard of living.

Having a will is a vital part of estate and inheritance planning. Without a will, the rules on intestacy apply to determine who shares the estate holder’s property.

It is also important that estate and inheritance planning are not seen as a once-and-done exercise. It should be an ongoing process that is regularly reviewed and adjusted as circumstances change. Life events such as the birth of grandchildren may involve updating wills and trusts to include provisions for new beneficiaries, setting up education funds or gifting to transfer wealth to younger generations in a tax-efficient way. For individuals facing health challenges, there may be a need to reassess long-term care provisions and insurance coverage to protect against potential healthcare expenses that could erode estate assets.

Tax laws and regulations are also subject to change, and updates to inheritance tax legislation can have implications for estate planning strategies. Advisers play a crucial role in keeping abreast of these changes and identifying new opportunities for tax efficiency. By staying informed and proactive, advisers can help clients adapt their plans to accommodate changes in their financial circumstances or tax laws, ensuring that their estate remains well-protected and optimised for tax efficiency.

Furthermore, ensuring that beneficiaries are well-positioned to benefit from the estate requires consideration and planning. It involves not only structuring the estate in a tax-efficient manner but also proactively addressing any potential tax liabilities that may arise.

Establishing mechanisms such as trusts can streamline the transfer of assets while minimising tax implications. By transferring assets into trusts, individuals can reduce the taxable value of their estate.

Moreover, trusts provide flexibility in asset distribution, allowing individuals to specify how and when beneficiaries receive their inheritance. Whilst the use of trusts has been reduced by legislative change, they do still form an important part of the equation. They are important for asset protection purposes (particularly for vulnerable beneficiaries) and on death of the first spouse (using an immediate post death interest trust) or a discretionary will trust.

Additionally, educating beneficiaries on their potential tax obligations is crucial for effective wealth transfer. A key cause of issues and frustrations in many instances is a lack of communication on the deceased’s wishes and plans ahead of their death.

However, providing them with the necessary resources and guidance to navigate tax matters ensures a smooth transition of wealth. Beneficiaries should understand their responsibilities regarding reporting and paying any taxes associated with their inheritance.

In summary

When planning for inheritance tax, it is essential to adopt a pragmatic mindset that prioritises both long-term financial sustainability and the wellbeing of beneficiaries. By leveraging exemptions, working with expert advisers, and aligning income requirements with tax planning strategies, individuals can effectively manage their estates while minimising tax liabilities.

While inheritance tax may seem daunting, it presents an opportunity for individuals to take proactive steps to safeguard their wealth and provide for future generations, ensuring that their legacy endures for years to come.

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