Your Guide to

Inheritance Tax & Estate Planning

UK Tax Year 2022/2023

ATTICUS
FINANCIAL PLANNING

Table of Contents

Introduction 1

Why IHT? 2

What is Inheritance Tax? 4

Who Pays the Inheritance Tax? 5

What is the Nil Rate Band? 6

What is the Residential Nil Rate Band? 7

Estate planning tools 8

- Why should I make a will? 8
- Lasting Powers of Attorney 10
- Exemptions & reliefs 11
- Gifts to reduce your IHT liability 13
  - » Outright gifts 15
  - » The use of trusts 15
- Types of trust arrangements 17
  - » Absolute / Bare Trusts 17
  - » Discretionary Trusts 17
  - » Interest in Possession Trusts (IIP) 18
- Purpose built trusts 19
  - » Gift Trust 20
  - » Discounted Gift Trust 20
  - » Loan Trust 20
- Business Property Relief Qualifying Investments 21
- Whole of Life Insurance 23

Step by step estate planning & IHT mitigation 24

Want to know more? 26

Introduction

Welcome to the Atticus Financial Planning Guide to Inheritance Tax & Estate Planning for the UK Tax Year 2022/2023. We hope you find this a useful guide and introduction to the quality of advice we are able to offer our clients.

If you would like to discuss any of the topics covered above in greater detail, please don't hesitate to book a free initial conversation with us here at Atticus Financial Planning.

Email us at info@atticusfp.co.uk or give us a call on 01420 446 777.

Atticus Financial Planning was born out of a dream to do things differently.

We believe in the importance of money, not as an end in itself, but as a facilitator of dreams. With true financial planning, money becomes a means by which lives can become richer and more fulfilled and individuals can be freed to follow their true purpose.

At Atticus Financial Planning we feel that our clients choose to partner with us in making their dreams a reality. Together we work to create a meaningful and rich future, built upon a sound and robust financial plan. This forms the foundations that allows them to flourish, not just financially, but also mentally, physically and spiritually.

Our aim is to offer simple, effective advice that works and makes a difference in the lives of our clients.

Most importantly, we understand that every person is unique. We therefore take the time to find out what your personal values, circumstances and goals are, before we put together your plan.

Contact us to start your journey to financial freedom, or find out more at www.atticusfinancialplanning.co.uk

The following Guides are also available from Atticus Financial Planning:

- Your Guide to Investments & Tax Planning
- Your Guide to Divorce & Pensions
- Your Guide to Pensions

Why IHT?

Inheritance tax (IHT) and Estate planning – for many people these are remarkably emotive subjects.

For some people, the purpose of working hard and building up an estate is to pass it on to the next generations, giving them a financial push start that will hopefully allow them to fulfil their dreams and lead a better quality of life; free from some of the struggles and worries that they themselves had to overcome. It's often about knowing that they have given their loved ones the best possible chance of succeeding.

It therefore comes as a shock for many of them that they may have to pay a substantial portion of that estate to HMRC upon their death. This is a bitter pill to swallow, especially when they have diligently paid their taxes every single year of their adult working life.

For a long time, IHT was tolerated as a tax on the wealthy few. However, due to recent steep increases in property prices, a freezing of the 0% IHT band on individual estates at 2009 levels and the longest bull run on stock markets in living history, more and more households are having to pay IHT.

The question more and more people are asking is, "What can we do to mitigate IHT and ensure that as much of our estate is passed to our loved ones as possible?"

Former Labour Chancellor Roy Jenkins famously described Inheritance Tax as 'a voluntary levy paid by those who distrust their heirs more than they dislike the Inland Revenue.'

Jenkins made the statement in 1986 when Capital Transfer Tax, which was the predecessor to Inheritance Tax, was repealed. This corresponded with the introduction of legislation around 'Potentially Exempt Transfers' which, in a nutshell, allows an individual to make a gift of any size provided that:

1. The gift is outright and there are no strings attached
2. The donor survives for seven years after making the gift

In the context of this new legislation, Roy Jenkins was correct. Theoretically, a person could give away everything they own to their beneficiaries and, if they survive for 7 years after making the gift, they will have overcome their IHT liability.

However, there are a number of fundamental flaws with this strategy. The donor still needs to somehow fund their day-to-day living. By gifting everything to their beneficiaries, they are placing their financial future in the hands of someone else. The

donor will effectively be relying on the recipient of the gift to provide for their financial needs until they eventually pass away.

Apart from relying on the fundamental good nature of the recipient of the gift, this strategy also fails to take into consideration what happens if the beneficiary predeceases the donor, or gets divorced and loses half the assets in the settlement? What is the situation if the beneficiary uses the assets to start a new business and the business goes bust? In these situations, the funds may not be available to help the donor, regardless of the best intentions of the beneficiary.

If Roy Jenkins' strategy is so obviously flawed, what is it that we can actually do to at least mitigate to some extent the impact of IHT?

There are a number of solutions available, depending on your personal circumstances and goals. It is however important to take advice on this area in order to ensure that it remains suitable for both you and your beneficiaries.

The intention of this guide is to provide a basic explanation of what IHT is and how it works. I will highlight what the main potential solutions are and I will provide a basic step by step plan to basic IHT and estate planning.

Please remember that everybody's circumstances are different and it is important to ensure that you take advice to confirm that your plans are suitable and implemented properly.

What is Inheritance Tax?

“Inheritance tax is a tax payable on your estate when you die. Everybody knows that!”

Unfortunately, this is a very common misunderstanding. The reason for this is that the largest proportion of IHT is collected by HMRC upon the death of an individual. However, it is not actually death that triggers the IHT liability. In reality, IHT is charged on “transfers of value”, which can occur during life (for example, a gift from one individual to another) or on death. A transfer of value occurs whenever you dispose of something and, as a result, your total net wealth is reduced.

For example, if you give someone £50,000 in cash and receive nothing in return, that is a ‘transfer of value’ of £50,000, as the value of your personal net wealth is reduced by £50,000. Similarly, if you give someone a car worth £10,000, that is a ‘transfer of value’ of £10,000.

The tax is generally calculated based on the value of your estate. So, what is included in your estate? Basically, if you are UK domiciled, it is everything you own worldwide. This includes your: house, boat, paintings, jewellery, holiday home, investments, life assurance policies not written in trust and the value of any gifts you made in the last 7 years.

When the value of your estate has actually been calculated, the taxman will look to take approximately 40% of the excess over the available Nil Rate Band.

Inheritance tax (IHT) must be paid no later than 6 months from the end of the month in which the deceased died. For example: if the person died in January, the inheritance tax is due by 31 July.

Who Pays the Inheritance Tax?

Liability for the tax is dependent on a number of factors, including provisions made in the will. There is a general presumption that the beneficiary of a bequest of property or buildings will be liable for the tax liability, while a further presumption exists that the personal representative of the estate will pay the tax on any gifts of cash or other asset out of the assets of the estate. The provisions of the will can, however, overturn these presumptions.

In relation to paying the IHT liability on Lifetime Gifts, the primary responsibility for any IHT arising on lifetime transfers falls on the donor. This will reduce or completely eliminate the Nil Rate Band the donor has available to shelter some of his estate from IHT, resulting in the overall tax on the estate being bigger. Additional IHT liabilities may arise when the donor dies within seven years of a making a gift. These liabilities usually fall on the recipient of the gift, who can potentially utilise taper relief to reduce the tax liability, depending on the amount of time that has passed since the gift was made.

It is important to note that HMRC will always first attempt to collect the tax from the correct person. However, if they are unable to pay, HMRC can approach anyone else connected to the transaction for payment. Therefore, if a beneficiary is unable to pay the tax on their share of the estate, HMRC can collect the tax liability from the personal representative of the estate.

What is the Nil Rate Band?

Every single person in the UK gets their own personal Nil Rate Band (NRB). This is the total value of your estate that can be transferred to others without creating an Inheritance Tax liability. There is no IHT liability on transfers of value between UK domiciled married couples/civil partners.

A strange fact about the NRB is that it is not tax free. Rather, this is a band of your estate that is taxed at 0%. The NRB is currently £325,000 and, since 9th October 2007, it has been possible to transfer the unused portion of the NRB between spouses/civil partners. This transferable allowance does not have to be claimed until the death of the surviving spouse.

Therefore, if the deceased spouse were to leave their whole estate to the surviving spouse, then the surviving spouse would receive the full estate, as well 100% of their deceased spouse's NRB. This means that the surviving spouse would have a total NRB of £650,000 (2 x £325,000) that can be used on their death to offset some of the IHT liability.

If the Mr.Smith leaves £130,000 to their son upon his death and the rest to his wife, this would utilise 40% of his NRB. This means that only the 60% unused proportion of Mr.Smith's NRB will be transferred to his wife.

The transferred Nil Rate Band is only claimable upon death and can only be used against the surviving spouse's estate.

It is important to note that the Nil Rate Band will be frozen at the £325,000 level until 5th April 2026. The implications of this are that, as individual estates increase in size over this period, more and more estate will become subject to IHT, resulting in a corresponding increase in government revenues from this source.

There is a large amount of planning that can be done utilising the NRB and it can become quite complex. It is therefore useful to take financial advice in order to ensure that you make the most beneficial decisions.

What is the Residential Nil Rate Band?

The Residential Nil Rate Band (RNRB) is an additional layer of exemption available on the estate of the deceased provided certain qualifying conditions are met. This is available on top of the individual's NRB and the unused proportion is also transferrable between spouses/civil partners. It has been available for deaths occurring from 6th April 2017.

It is important to note that, on second death, the surviving spouse's Personal Representatives are able to claim both the deceased's RNRB and the unused RNRB of their late spouse, similar to the procedure used for claiming the transferable Nil Rate Band.

The RNRB will be available if a person's estate includes their home and it is left to their direct or lineal descendants such as their children, grandchildren or great grandchildren. It is very important to note that the amount of RNRB available is limited to the value of the home that is left to the direct descendants.

For the purposes of this particular exemption, a person's home is any dwelling house they owned, or had owned, and occupied at some stage as their home while they owned it. There is no minimum period of occupation. Therefore, an elderly person may move into a house and only live there for a short time, before being taken ill and having to go into care. HMRC would normally regard this person to have established a home for RNRB purposes.

As you can see, there is quite a broad interpretation of a home and it is determined on a case-by-case basis. It is perfectly feasible that a caravan or house boat could qualify for the RNRB provided it meets the requirements.

Only one property can qualify as a home for RNRB purposes, therefore, in cases where the deceased owned a number of potentially qualifying homes, their personal representative will have to nominate a single property.

The RNRB is currently £175,000 per person (frozen at this level until 5th April 2026). Between a married couple/civil partners this would amount to a further £350,000 on top of the existing joint NRB of £650,000. This means that a married couple/civil partnership could feasibly leave £1,000,000 to their children, without triggering an IHT liability.

Once an individual's estate exceeds £2,000,000, the available RNRB is tapered by £1 for every £2 over the £2,000,000 mark. Therefore, once an estate exceeds £2,350,000 (£350,000/2 = £175,000), the RNRB will be tapered away completely. Where the individual is also in possession of their deceased spouse's/civil partner's unused RNRB, then this could increase up to £2,700,000 (£700,000/2 = £350,000) before the RNRB is fully tapered away.

Once again, it is important to note that this can become a remarkably complex area of planning and it is therefore very important that you take some advice when you are drawing up your wills and putting your plans in place.

Estate planning tools

There are a number of different options or “tools” in order to help people mitigate their IHT liabilities and ensure that the funds are distributed correctly.

Over the next few pages, I will be looking at the following options and their implications:

- Wills
- Powers of Attorney
- Exemptions
- Gifting and Trusts
- Business Property Relief
- Life Insurance

This is by no means a comprehensive breakdown of all the potential IHT/Estate planning tools, but it does provide a basic understanding of some of the more common strategies applied.

Why should I make a will?

For some people, the impact of IHT on their estate is not a concern. Their loved ones will get what they get and that should be sufficient. If there is money left over when they die, then their children benefit, but if not, the absence of any substantial inheritance will not disadvantage potential beneficiaries in a significant way.

I can sympathise with this approach up to a point. These people have worked hard all their lives and are generally planning to make the most of the assets that they have built up to enjoy their twilight years. In addition to this, they have made plenty of sacrifices along the way to hopefully get their children to a point where they are properly equipped to function independently in the modern world. Surely that is enough.

This is an emotive area, often ruled by personal preference and cultural influences and I don’t think there is a right or wrong answer here. However, a lack of concern about IHT and Estate planning somehow excludes the individual from the realities of death.

Having talked with a number of solicitors who specialise in probate, the general consensus is that it takes an average of 6 months to wind up a fairly simple estate. I can understand why. Death is an administrative nightmare. I had a client whose

husband passed away. While clearing his office, she found a box full of share certificates hidden at the back of one of his filing cabinets. She had no clue what to do with them. It took us a good month to sort through them and find out which had value and which did not. When we consider the accumulations of a lifetime, it is not surprising that it takes an average of 6 months to unravel all its complexities. In another case, it took us a year to sort out pensions and a trust for a deceased client, as the beneficiary had moved to Australia.

Why is this important? It highlights that the main reason for putting a will in place is to help simplify an already complicated process.

By putting a will in place, you can ensure that there are no doubts or disputes about who should receive what. English literature is full of stories where disputed bequests have broken up whole families. This can be largely avoided by putting a will in place.

It is also important to remember that if you do not have a will in place, your estate will be divided up in line with the intestacy rules, with potentially disastrous and complicated consequences for your loved ones.

A will can ensure that your assets go to the people you intended and that your estate is wound up by personal representatives of your choosing. This can take the burden off some of your loved ones in order to allow them to grieve, knowing that the process of winding up the estate is being undertaken.

For people with young children, a will can appoint guardians and make provision for children's maintenance should both the parents die.

For many, there are charities and causes that are close to their hearts. They may wish to leave a legacy to a particular charitable institution, as a way of supporting them and saying thank you. This can only be done through their will. By leaving a portion of the estate to charity, this can also reduce the rate of IHT chargeable against the remainder of the estate, thus creating further savings.

Lastly, by using a will, you can take a number of steps that may save Inheritance Tax and ring fence assets for specific loved ones.

As we can see, in most of the situations above, you use a will to protect your loved ones. This can be done by providing them with a financial legacy, ensuring that they are not overwhelmed by the need to administer the estate and protecting them from doubt and confusion at a point where they cannot ask you what you really wanted. Therefore, you are making the will for the benefit of those you love. For this reason, a will should form the foundation of whatever Estate planning you do. The fact that someone is not concerned about paying IHT should not be a reason not to make a will.

Lasting Powers of Attorney

A Lasting Power of Attorney (LPA) allows your loved ones to take care of you and your finances if you become unable to do so yourself.

There are two types of LPA:

1. A "Property and Financial Affairs" LPA allows your loved ones to deal with paying your bills, buying and selling your property and managing your bank accounts and investments. This type of LPA will come into effect as soon as it is registered, giving the attorney the right to make decisions about your property and financial affairs, even if you have not yet lost the mental capacity to make your own decisions. There are options to ensure that this does not happen, but it is important that you discuss this with your solicitor to ensure that the correct wording and clauses are included when drafting the LPA.
2. A "Health and Welfare" LPA covers decisions about health and care and even deciding where you are to live. This can only be used if someone is incapable of dealing with such matters themselves. The powers for this LPA can only be exercised once the person who made it has lost the mental capacity to make these decisions.

I often have clients who question whether they need the latter type of structure in place. There are concerns about giving up power over crucial aspects of their life. I understand this fully. These are real fears and should be discussed openly with your solicitor and loved ones.

The problem is that the need for an LPA generally creeps up on families. When the need is suddenly recognised, either due to the creeping effects of dementia or the sudden loss of capacity due to a traumatic event, it's too late.

Not having an LPA in place means that a complex process will have to be undertaken where the court of protection has to appoint a deputy to look after the person who has lost capacity. If this is you, then it means that you have no choice about who will be looking after your affairs for the rest of your life. This is a lengthy process and can leave people in great difficulty while it is completed. For example, if one joint account holder loses mental capacity, banks and building societies can decide whether or not to temporarily restrict the use of the account to essential transactions only.

It sounds counterintuitive, but by having an LPA put in place by a suitably qualified professional, you actually ensure that you retain an element of control over how your affairs are managed, even after you have lost mental capacity to act, should it come to that.

Exemptions & reliefs

The government has provided us with a number of exemptions and reliefs that can be used to mitigate your IHT liability. I have set these out below:

1. Gifts between UK domiciled spouses/civil partners

Gifts between UK domiciled spouses are exempt from IHT. However, A UK domiciled spouse/civil partner can only make IHT free gifts to a spouse/civil partner who is not UK domiciled up to a maximum allowance of £325,000. This is a lifetime allowance, therefore it does not replenish after 7 years, like the Nil Rate Band. Anything in excess of this is treated as a Potentially Exempt Transfer.

Therefore, the maximum that can be transferred from a UK domiciled spouse/civil partner to a non-domiciled spouse upon death free from IHT is £650,000 (NRB + £325,000 lifetime allowance). Anything above that will be subject to IHT.

2. Annual Gift Allowance

Each year an individual can gift away £3,000 free from IHT. They can also use the previous year's allowance, if this was not utilised before.

3. Gifts under £250

Gifts of up to £250 can be made to as many individuals as the donor wants. Although these gifts cannot be made to anyone who has already received a gift of their whole £3,000 annual exemption. These gifts will also be Inheritance Tax exempt.

4. Wedding gifts

Certain wedding gifts may be treated as exempt for IHT purposes provided they were made before the wedding and the wedding actually takes place. These include:

- Gifts to a child worth £5,000 or less
- Gift to a grandchild/great grandchild of £2,500 or less
- Gifts from another relative/friend of £1,000 or less

5. Gifts for maintenance

Gifts to help pay the living costs of an ex-spouse, elderly dependent or a child under 18 or in full-time education could potentially be exempt. This can be a complex area, so if in doubt, take advice.

6. Gifts out of normal expenditure

Gifts out of your excess income may be immediately exempt for IHT purposes provided:

- The gift is made out of income (interest, dividends, earnings, pension, rental etc.).
- The intention is to make the gift regularly (for example, once a year). The amount does not need to be the same each year.
- The gift must not affect the donor's standard of living.

It is important to note that it is not possible to live on capital, while gifting away income. This would invalidate the exemption.

7. Agricultural Property Relief

Agricultural Property Relief (APR) is a relief from IHT on the agricultural value of UK agricultural property which has been:

- Owned and occupied by the owner for the purposes of agriculture for at least two years, or
- Owned for seven years, and occupied by the owner (or someone leasing the property) throughout for agricultural purposes.

APR is given at 100% if:

- The owner has vacant possession of the property or they have a right to vacant possession within 12 months.
- The land is let and the tenancy started on or after 1st September 1995.

50% relief may be available in other cases.

This is a very complex area and it is crucial that advice is taken. Do not simply assume that a piece of land qualifies by virtue of the fact that it is picturesque and there a few cows randomly grazing on the fields.

8. Business Property Relief

Business Property Relief (BPR) is a tax relief that was made available by the government in 1976 in order to:

- Encourage investment into certain types of trading businesses and;
- To prevent the sale and dissolution of family-owned businesses in order to pay IHT upon death of the owner.

Subject to this relief, holdings in qualifying businesses are exempt from IHT after being held for more than two years. BPR is available on:

- Businesses.
- On an interest in a business or a partnership.
- On unquoted shares and;
- On land, buildings, plant and machinery when utilised in a qualifying trading business.

Once again, this is a very complex area and advice should be taken in order to ensure that you do not fall foul of any legislation.

To summarise

The majority of the above exemptions are not going to make a huge difference, but to quote a popular tag line, "Every little helps."

The key exemptions above are the spousal allowance, gifts out of normal expenditure, Agricultural Property Relief and Business Property Relief. While these can make a big difference if used correctly, they are also very complex and require a good deal of understanding to avoid pitfalls. Proceed with care. I have seen numerous occasions where this kind of planning has come unstuck and I strongly recommend that you take advice.

Gifts to reduce your IHT liability

There are a number of different ways to mitigate an Inheritance tax liability. The most common method is to reduce the size of the estate by gifting further assets away, in addition to the gifts made in line with the exemptions.

These gifts can take two forms:

1. The gift can be made outright to the beneficiary
2. The gift can be made into a trust for the benefit of the beneficiary

Before we look at the merits of each type of gift, I think it is important to clarify the features of the different types of gifts.

Potentially Exempt Transfers (PET)

This is a gift that is potentially exempt from Inheritance Tax, provided the donor survives for seven years after making it. There is no limit on such transfers. In other

words, you can give away as much as you want at any time, without triggering a lifetime tax liability. This is an excellent way of transferring excess value out of the estate.

If the donor dies within seven years of making the gift, the exemption is voided, the gift becomes chargeable for IHT purposes and the value of the gift/s is added to the donor's estate, eroding the available Nil Rate Band. There may be tax payable by the recipient of the gift, but this is an area I will not cover now, as it would simply muddy the waters.

The type of asset being gifted is irrelevant. It can be cash, property or shares. The key thing is that the donor gifts it directly to their selected beneficiary and they receive an absolute right to the capital and any income it may produce.

If a donor retains use of the gift or any benefit from it, this could be treated as a gift with reservation. If this is the case, the gift is treated as if it didn't occur. So, if a parent gives their house to their children but continues to live there (without paying a market rent, regularly reviewed), the value of the house on death will be chargeable to IHT.

Chargeable Lifetime Transfers

A chargeable lifetime transfer (CLT) will arise where an individual makes a gift into a relevant property trust. This includes Discretionary Trusts and Interest-in-Possession Trusts. However, it does not include Absolute Trusts, as these qualify as Potentially Exempt Transfers, as we will discuss later.

A CLT will be subject to an immediate charge to IHT at 20% where the value of the CLT, when added to any other CLTs made by the settlor in the preceding seven years, exceeds the IHT nil rate band (that is the main nil rate band of £325,000 per person, not including any transferable or residential nil rate band).

For example, the donor makes a CLT of £200,000 in 2016 (assume they have made no other CLTs in the past) and a further £200,000 in 2018. There will be no immediate tax liability on the CLT made in 2016, as this is within the £325,000 NRB. If we look back 7 years from the date of the gift in 2016, no other CLTs have been made.

However, the gift made in 2018 will trigger an immediate IHT liability. The reason for this is that we have to look back over the last 7 years from the date the gift was made, we can see that a CLT of £200,000 was made in 2016. This needs to be deducted from the available NRB in 2018. This will reduce the NRB available to £125,000. The CLT in 2018 will therefore exceed the available NRB by £75,000, resulting in an immediate IHT liability of £15,000 (£75,000 x 20%).

The liability to IHT on the CLT rests with the person making the gift, although the settlor and trustees can agree between them as to who pays.

If the settlor were to survive for seven years from the date of the gift there will be no further IHT payable, but there is no refund of any IHT paid at outset.

Outright gifts

This is the simplest option and involves simply gifting the assets directly to your beneficiaries.

Advantages:

- There is very little cost involved and it is simple
- There is no limit to the size of the gift that can be made, as this is regarded as a potentially exempt transfer (PET).
- If the donor survives for more than 7 years, the value of the gift will no longer form part of their estate for IHT purposes.

Disadvantages:

- The donor has to give up all access to the funds.
- The donor has no control over how the assets are used or invested.
- If they die within 7 years of making the gift, the full value of the gift (at the date it was made) will be added back to their estate for Inheritance Tax (IHT) purposes, eroding away their NRB.
- The gift forms part of the beneficiary's estate and is therefore vulnerable to attack by third parties. Therefore, if the beneficiary is declared bankrupt or gets divorced, the assets could be lost in the settlement.
- Beneficiaries generally need to be adults and relatively mature in order to receive the gifts, particularly if they involve large sums of money. A profligate beneficiary would likely fritter the gift away.

The use of trusts

Many people want to make gifts during their lifetime:

- In order to reduce the size of their estate for IHT purposes
- To provide a financial foot-up for children and grandchildren
- To create a legacy that will provide their beneficiaries with certain advantages

In the world we live in, the gift of a bit of money, a house, or the funds to pay for university can be life changing. However, gifting money to a person under the wrong conditions can either exacerbate a problem or simply result in the money being lost.

Unfortunately, the donor often feels that they cannot make the gift as:

- They are not comfortable giving up control of the assets
- The beneficiary is irresponsible and cannot be trusted to use the legacy sensibly
- The beneficiaries are minors and cannot hold the funds themselves
- Their child is engaged in a volatile marriage or business venture and the donor is scared that, should the marriage or business fail, the gift will be lost

The loss of control and lack of security and safeguards often makes a direct gift to an individual or group seem very unattractive.

This is where utilising a trust structure can be very useful. A trust is a way of managing assets (money, investments, land or buildings) for the benefit of the intended beneficiaries.

Trusts involve:

- the ‘settlor’ - the person who puts assets into a trust
- the ‘trustee’ - the person who manages the trust
- the ‘beneficiary’ - the person who benefits from the trust

Trusts are set up for a number of reasons, including:

- to control and protect family assets
- to pass on assets whilst the donor is still alive
- to pass on assets upon death (a ‘will trust’)
- under certain circumstances where someone dies without a will (in England and Wales)

Types of trust arrangements

There are different types of trusts and they each have differing levels of flexibility and are taxed differently. The trust that is used will depend on what the settlor is trying to achieve.

Absolute / Bare Trusts

An Absolute Trust (also known as a Bare Trust), is an arrangement where the settlor gives trustees an amount of money or assets to look after for a specific beneficiary (or beneficiaries). The main difference from other types of trust is that the trustees have no discretion to change the beneficiary at a later date.

Settlors must therefore be certain of who they wish to benefit from the trust, because once the trust in place there is no flexibility to amend the decision.

There are several reasons why a settlor may choose this particular structure:

- the settlor is certain of who they wish to benefit
- to make gifts to minor children
- to make gifts to adults who cannot manage their own affairs
- to ensure that a lifetime gift is a potentially exempt transfer and won't be subject to an immediate IHT charge

Gifts into absolute trusts are treated as potentially exempt transfers (PET). There will be no immediate IHT charge, and they will escape IHT altogether provided the settlor survives the gift by seven years.

The gift is specific and there is no discretion to change the beneficiary at a later date, therefore the assets are effectively treated as belonging to the beneficiary. This allows interest and gains to be offset against the beneficiary's personal tax allowances, but also means that the assets are treated as part of their estate or IHT purposes should they die. The extent of this is demonstrated by fact that a minor child can demand the funds held in trust as soon as they turn 18. This can potentially have undesirable consequences for them.

Discretionary Trusts

Discretionary Trusts are used where the settlor wishes the trustees to have a discretion over who will benefit and when. The beneficiaries won't have an automatic right to benefit from the trust assets or the income/returns generated from it. The discretion

of the trustee is usually limited by the settlor selecting different classes of beneficiaries. The trustee can make a decision to pass assets or income to any individual who falls within a class of potential beneficiaries chosen by the settlor at the outset.

A settlor may therefore select their children, grandchildren and future great grandchildren as potential beneficiaries.

By giving this discretion to the trustee, the settlor can ensure that the trustees are able to put the right money, in the right hands at the right time.

The discretion of the trustees also means that the potential beneficiaries have no right to demand the assets within the trust, as they are only potential beneficiaries and are not absolutely entitled to any of the trust assets. This also means that a third party in a divorce or bankruptcy action involving a potential beneficiary, cannot attack the legacy as part of their action, as the trust assets do not legally belong to the potential beneficiary. This offers a high level of protection and control over the trust assets.

This high level of flexibility and control means that Discretionary Trusts are very popular. In order to limit their use, they are subject to the relevant property regime. As a result of this, gifts into Discretionary Trusts are treated as Chargeable Lifetime Transfers (CLT) which means:

- Each individual can only gift up to their available NRB (currently £325,000) into a Discretionary Trust. Exceeding this amount in any seven-year period will result in an immediate IHT liability of 20% on the excess over the NRB. Once 7 years have passed, the gift into trust will fall out of the settlor's estate, the settlor's NRB will be restored and a further gift into the Discretionary Trust can be made.
- The trust assets may be subject to periodic charges of 6% over the available NRB every 10 years, as well as potential exit charges.
- The trust itself is taxed as an additional (45%) rate taxpayer.

Interest in Possession Trusts (IIP)

These are trusts which leave a right to income to a specific beneficiary, while the right to the capital or asset itself is left to a different set of beneficiaries, subject to the discretion of the trustees.

A common example of their use is upon death where a right to use a property is left to the surviving spouse, but the property itself will go to the children upon the spouse's death.

Another example may be an investments portfolio gifted into an IIP, with the income

and dividends reserved for the benefit of one individual (known as the life tenant), while the investments themselves will go to another class of beneficiaries upon the life tenant's death.

These trusts can be set up by a will or a gift during life. IIP trusts created on death are not treated as 'relevant property' and so the trust will not be subject to periodic or exit charges. Instead, the value of the trust will form part of the life tenant's taxable estate on their death.

Lifetime gifts into IIP trusts are now chargeable lifetime transfers (CLTs) that are subject to IHT at 20% if they exceed the settlor's nil rate band. The trust is classed as a relevant property trust which means that periodic charges apply every 10 years, as well as exit charges when capital is paid out to beneficiaries. However, the trust assets are not deemed to form part of any of the beneficiaries' estates.

Purpose built trusts

As we can see above, there are a number of different trust structures (Absolute, Discretionary, IIP) that you can choose to use. I had a great mentor, Ian Dyall, who described these structures as the chassis upon which every trust is built. The structure will determine the amount you can gift into the trust, the level of control and protection and the tax treatment of the assets.

Once you have selected the chassis, you then need to choose the functionality of the trust. This choice can allow a settlor to choose to give away:

- Both the capital the growth/income
- The capital only while carving out an income for life
- The growth, while retaining access to the capital
- Excess income only to take advantage of the gifts out of excess income exemption

The choice of each trust will depend on the settlors aims and personal circumstances.

We will look at the following options:

- Gift Trust
- Discounted Gift Trust
- Loan Trust
- Excess Income Trust

All the trusts above can be written on a Discretionary or Absolute basis.

Gift Trust

This is a trust for a settlor who has more income and capital than they need. They are therefore keen to make a gift of the assets into the trust, where they give up all access to the capital and any income or growth.

Once the assets are gifted into trust, the settlor will need to survive for 7 years before the value of the gift will fall out of their estate for IHT purposes. Any growth achieved on the assets will be outside of the settlor's estate immediately.

Discounted Gift Trust

A discounted Gift Trust is where the settlor gifts a certain amount of money into the trust, but also carves out a right to "income" for themself from the gifted assets. The income will be paid to the settlor at the same level for the rest of their life.

This is particularly beneficial for individuals who are asset rich, but income poor.

The value of the settlor's retained future payments can offer an immediate reduction in the amount treated as being a gift for IHT purposes, known as a discount. The discount is based on the hypothetical price a buyer would be willing to pay for the settlor's right to future capital payments.

The availability of the discount means that there can be a substantial IHT saving on a portion of the assets settled into the trust from day one. However, the size of the discount will be dependent on several factors such as life expectancy and the level of payment.

In the past, many Discounted Gift Trusts were set up on the basis of the discount. This should not be the case. The purpose of this trust is to gift assets away, while retaining an income. If the income is not required and not spent, the income will simply build up in the settlor's estate again, to be subject to IHT upon the settlor's death. This defeats the purpose of the gift into trust.

Loan Trust

This is very light touch Estate planning.

The settlor creates a trust and then lends an amount of money to the trustees who invest the funds for growth.

The value of the loan still forms part of the settlor's estate and can generally be reclaimed at any time, in full or in segments.

Any growth achieved on the investment goes straight into trust for the benefit of the beneficiaries. It never forms part of the settlor's estate for IHT purposes. Over time, the growth accumulated in the trust can be quite substantial.

This is particularly beneficial for people who want to reduce the speed at which their IHT liability is growing, by gifting away the growth on the assets without actually giving away the assets themselves.

Excess Income Trust

As discussed earlier, gifts out of normal expenditure are automatically exempt for IHT purposes, provided they meet the exemption requirements.

This can prove a very useful exemption, when individuals have far more income than they need. However, having excess income does not mean that the prospective donor wants to simply give the money directly to their selected beneficiary. The beneficiary could be too young, irresponsible or engaged in an unstable marriage or business venture.

The exemption, however provides the opportunity to make gifts of any amount of money into a Discretionary Trust, without triggering an immediate IHT liability.

This can allow the settlor to make substantial contributions into a Discretionary Trust every year, without having to pay a lifetime IHT charge. The gifts will automatically be outside of their estate, but the Discretionary Trust will ensure that the legacy is protected from third party attack should the intended beneficiaries ever be involved in divorce or bankruptcy actions. This again prevents an irresponsible beneficiary from simply frittering the money away.

Business Property Relief Qualifying Investments

There are certain investments that qualify for the Business Property Relief as discussed earlier in the guide.

This can be a very useful option that can exempt assets held within qualifying investments from IHT within 2 years without having to actually gift the assets away.

Under certain circumstances, the investment may also qualify for Replacement Relief and would therefore be immediately exempt from IHT.

The advantage of using this approach is that it can reduce an IHT liability far quicker than traditional gifting, without having to physically give up control of the assets.

There are a number of investments available to that qualify for BPR. These include:

- Enterprise Investment Schemes (EIS)
- Certain shares held on the Alternative Investment Markets (AIM)
- Purpose built IHT Mitigation Investments. These are known by a number of different names, but for the purposes of this guide we will refer to them as Inheritance Tax Services (ITS).

Some of these (EIS and AIM) portfolios are focused on achieving high levels of growth and, as a consequence, are extremely volatile and very risky. For these investments qualifying for BPR is an ancillary benefit, with the focus being on high returns over a long period of time. These can prove very volatile and be very illiquid and may not be the ideal vehicle for someone whose main focus is capital preservation and IHT mitigation.

This brings us to the ITS, which qualify for BPR with a focus on capital preservation. The standard structure for these is that the investor buys shares in an unquoted trading company, run by the investment provider. The funds are invested on a discretionary basis by the investment managers who looks for underlying investments capable of achieving predictable revenues and returns. It is however, important to note that the returns are not guaranteed. In addition to this, investors are still often investing into a single unquoted company, which will always remain a high-risk venture. In these situations, investors need to balance the risk of the value of the investment falling dramatically against the possibility of mitigating a 40% loss to IHT.

The providers of these kinds of investments claim that there is a high level of liquidity from the ITS, with assets capable of being realized within 15 working days. My experience of this is true, but it is difficult to know what liquidity would be like if there was a run on these kinds of assets, so it is always important to be cautious.

Once the investor has held the shares for two years, they are exempt from IHT, provided the investor continues to own the shares on the day that they die.

Unfortunately, many people only start to consider IHT planning when they get a diagnosis of illness and reduced life expectancy. This means that it is generally too late to use any of the standard solutions to mitigate IHT. They will not qualify for insurance; due to limited life expectancy and they normally do not have sufficient life expectancy to survive for 7 years after gifting assets away. The whole purpose of the 7-year rule is to prevent death bed bequests that remove the bulk of assets from the estate.

In these circumstances ITS investments can really come into their own. Provided the investor has a reasonable prospect of surviving for the next 2 years, they can exempt a portion of their estate for IHT purposes.

These are also particularly useful in situations where a client has lost mental capacity and is subject to a power of attorney. There are restrictions on gifting for IHT planning purposes placed on the attorney and any such planning would first need to be signed off by the Court of Protection. However, attorneys can still invest on behalf of the donor. This leaves the door open to potentially using investments that qualify for Business Property Relief. After two years, these investments will be exempt for IHT purposes.

Whole of Life Insurance

This is a solution that gets a bad rap, which is no longer justified. Part of the reason for this is the legacy of the stereotypical door-to-door insurance salesmen, who would plod the streets, collecting premiums and marking payments in little, dog-eared receipt books.

These days, insurance products are more sophisticated and their use is applied far more scientifically. Furthermore, the non-payment scandals of years past have largely faded into history due to the positive impact of social media, activist consumer champions and rigorous regulation.

The reality is that Whole of Life Insurance can be a very efficient way of effectively pre-paying the IHT liability. The purpose of the policy is to make funds available to the deceased's beneficiaries to pay the IHT liability in order to allow the release of the estate for distribution.

This is done by taking out a Whole of Life assurance policy to cover all/some of the IHT liability. The policy is written in trust, so that the proceeds of the policy do not form part of the deceased's estate upon death and can be utilised before probate is granted.

This means that upon death, the policy will pay out a tax-free lump sum into the trust. This provides a fund to pay the IHT liability.

While this solution is much maligned, it remains probably one of the most reliable, easy to manage solutions to mitigating an IHT liability, thus allowing wealth to be passed on to loved ones.

Step by step estate planning & IHT mitigation

One of the things I enjoy about Estate planning is that it can be fairly creative. There are a number of potential solutions and each has its merits. It is seldom the case that a single solution solves all the problems. It therefore becomes a bit like putting together a jigsaw puzzle, where we mix and match the various options to create an overall strategy that suits the individual's circumstances. Applied correctly, your financial adviser can save you colossal amounts of money with a well-structured IHT plan.

It is not a very formulaic process and no one is going to build an app that takes all the emotional factors that surround Estate planning into consideration.

Despite this, I still follow a basic process when creating a plan to mitigate IHT and ensure that assets are distributed in line with my client's wishes. I will lay it out as follows:

1. Ensure that a will is in place and up to date.
2. Take steps to equalise estates to ensure that each party to a marriage/civil partnership has sufficient assets in their own name available to meet their individual bequests as per their will.
3. Ensure that Lasting Powers of Attorney have been put in place and are suitable.
4. Look to see which assets may be exempt due to reliefs that may be available.
5. Consider what the client can afford to gift away. Is it income or capital?
6. Look to gift away surplus income or capital by:
   a. First utilising all exemptions
   b. Should any further gifts be made outright or into trust?
   c. If into trusts, what type of trust?
   d. If into trust, will we need to retain access to the capital or carve out an income for the client from the assets being gifted?
7. Once all gifting has been completed, it is important to determine whether we can mitigate some IHT by using investments that qualify for Business Property Relief.
8. If there is any outstanding IHT liability, is there an option to cover this with a Whole of Life Insurance policy?
9. Review the strategy annually to make provision for legislative changes and ensure that the plans remain suitable.

This outlines my basic thinking. In reality, each part of the planning process is far more complex and in-depth than this, but by following this basic structure, it can make sure that we follow a tapered path where we gradually reduce the outstanding IHT liability and also cover the majority of the solutions we have available.

As you can see, we always start with the will as the foundation, with the rest being applied in a structured process to remove the excess assets and income from the scope of IHT through gifting or utilising reliefs and eventually prepaying the remaining IHT liability using Insurance.

To help with this process, I have included a flow chart below. This is a useful decision tree that can help you ask the right questions to get you to a point where you know which options might be suitable for your needs. However, it is only a guide. There may be personal circumstances or unforeseen legislation or rules that impact your particular situation that you are unaware of. This flow chart also cannot tell you if you might get a better result using a number of different solutions. Therefore, it is always best to take some advice.

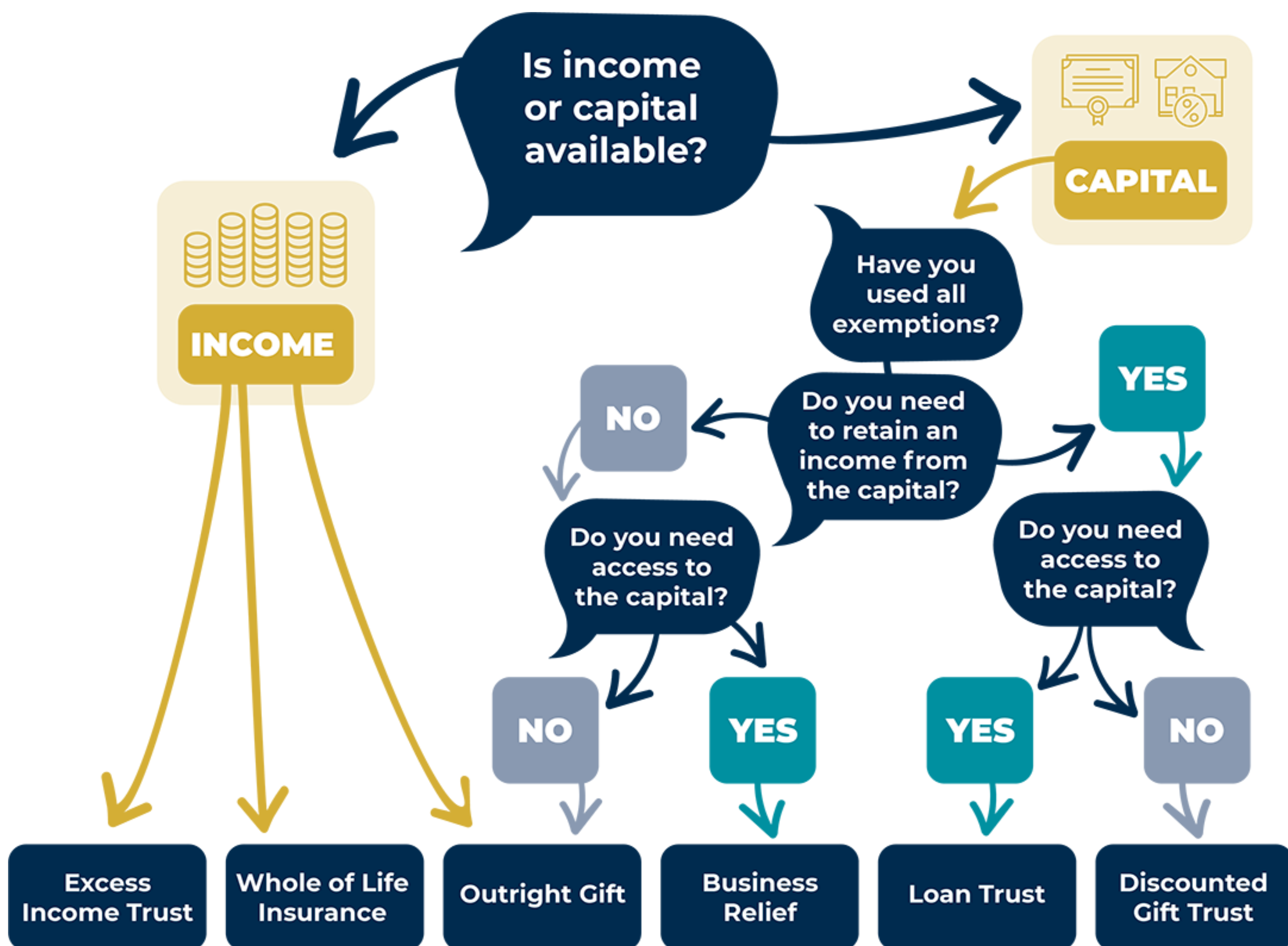

Figure 1 : IHT & Estate Planning Flow Chart

Want to know more?

If you would like to discuss any of the topics covered above in greater detail, please don't hesitate to book a free initial conversation with us here at Atticus Financial Planning.

Email us at info@atticusfp.co.uk or give us a call on 01420 446 777.

About the author

Abraham Uys
Director & Chartered Financial Planner

Abraham is the Principal at Atticus Financial Planning and has over 15 years' experience in the financial services industry. Abraham is a chartered member of the Chartered Insurance Institute (CII) and a Fellow of the Personal Finance Society (PFS).

Abraham has advised clients from a diverse range of backgrounds and personal circumstances. He has also been an adviser for long enough to have weathered a variety of economic conditions, including the crashes of 2008 and 2020, the Greek debt crisis and the extended bull market from 2009 to 2019. As a result, he brings a great depth of expertise to the table and is able to provide advice based on knowledge and understanding, honed by experience.

Abraham has always believed that financial advice should be offered on a fixed fee basis, determined by the time involved in completing the work and the value provided to the client. He also believes that cost is the enemy of performance and that adopting a cost-effective approach to investing can make a huge difference to the end result.

Abraham loves any sport that involves a ball, with a special place in his heart reserved for rugby. He also loves cooking and afflicting his family with his attempts at playing guitar.

Contact us to start your journey to financial freedom, or find out more at www.atticusfinancialplanning.co.uk

Disclaimer

This guide is intended as general guidance only and does NOT constitute accountancy, tax, financial, investment or other professional advice. The author makes no representations or warranties with respect to the accuracy or completeness of this publication and cannot accept any responsibility or liability for any loss or risk, personal or otherwise, which may arise, directly or indirectly, from reliance on information contained in this publication.

Please note that tax legislation, the law and practices by Government and regulatory authorities (e.g. HM Revenue & Customs) are constantly changing. We therefore recommend that for accountancy, tax, financial, investment or other professional advice, you consult a suitably qualified accountant, tax advisor, financial adviser, or other professional adviser.

Please also note that your personal circumstances may vary from the general examples given in this guide and your professional adviser will be able to give specific advice based on your personal circumstances.

This guide covers UK taxation only and any references to 'tax' or 'taxation', unless the contrary is expressly stated, refer to UK taxation only. Please note that references to the 'UK' do not include the Channel Islands or the Isle of Man. Foreign tax implications are beyond the scope of this guide.

Please note that this is not a 2plan wealth management Ltd document and has not been created or verified by 2plan.

Copyright © 2020-2022 by Atticus Financial Planning Ltd
www.atticusfinancialplanning.co.uk
info@atticusfp.co.uk
01420 446 777

All rights reserved. No part of this book may be reproduced or used in any manner without written permission of the copyright owner except for the use of quotations in a book review. For more information, address: info@atticusfp.co.uk

Third Edition, April 2022 - This ebook is provided free of charge and for digital distribution only.

Design & Illustration by BHWW www.bhww.co.uk

ATTICUS
FINANCIAL PLANNING

Tax planning is not regulated by the FCA.

Your home may be repossessed if you do not keep up repayments on your mortgage.

Investments can go up as well as down, you may not get back the amount you originally invested.

Atticus Financial Planning Ltd is an appointed representative of 2plan wealth management Ltd. It is authorised and regulated by the Financial Conduct Authority and is entered on the Financial Services Register (www.fca.org.uk) under reference 943598. Registered Office: 5 Doe Mews, Medstead, Alton, Hampshire, GU34 5TG. Registered in England & Wales: 12825620.