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Inheritance tax: passing on wealth to the children

The significance of inheritance tax and succession planning has shot to the top of the agenda as the question of long-term care costs has erupted. Liz Cuthbertson, partner at Mercer & Hole, examines the key IHT points to consider and the importance of taking action in good time

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The family home is often the most valuable asset but it can be the most difficult asset to plan for when it comes to trying to ensure it passes down to the children or next generation. The Conservative party manifesto includes proposals to take the family home into account when evaluating the contribution a person will make towards care costs, whether an individual receives care in their own home or needs to go into a care home.

In general, people are living longer and so, if only just statistically, some will require care at some stage during a lifetime. Age-related diseases like Dementia and Alzheimer's can, unfortunately, result in some very long periods of care and in some cases this can be many years. Consequently, the house will become vulnerable to being lost in care fees if all other resources have already been used up.

The increasing cost of care must also be taken into account and therefore there must be adequate consideration of a person's own needs while also making provision for their children or other beneficiaries.

All of this leads me to suggest that it is more important than ever to consider inheritance tax (IHT) and succession planning early enough. If there is sufficient wealth and affordability, giving away assets in lifetime can secure their succession to the persons of choice. If the individual is already anticipating care costs, they cannot do this and so again early consideration of all options is essential.

Cashflow planning

Before giving away wealth, the first step should be to consider what is required for one's own needs. Cashflow planning will analyse the long-term income and expenditure position to see exactly how much is likely to be surplus to your own requirements.

Income sources reduce after retirement yet some sources of expenditure typically increase. It is important to understand how different sources of income will meet your overall expenditure, for how long, and whether there is likely to be a deficit or a surplus.

This exercise will also enable you to see whether the family home will be vulnerable to being used to fund care costs or not. Detailed cashflow modelling using different assumptions can establish the worst and best case positions.

It is then possible to determine the sort of gifts you may wish to make to ensure they are carried out as tax efficiently as possible.

Gifts

Gifts to individuals can either be exempt gifts or potentially exempt gifts. Exempt gifts will reduce the estate of the donor immediately while a potentially exempt transfer (PET) will reduce the donor's estate after the donor has survived a full seven years from the time they made the gift.

Exempt gifts

Section 21 of the Inheritance Tax Act 1984 deals with the normal expenditure out of income exemption.

If a gift (or, more precisely, a 'disposition') is exempt, then for IHT purposes it is irrelevant whether or not the donor survives for seven years. Its value reduces the value of the donor's estate immediately.

For the exemption to apply, it must be shown that a transfer of value meets the following three conditions:

1. it formed part of the transferor's normal expenditure;
2. it was made out of income (taking one year with another); and
3. it left the transferor with enough income to maintain his/her normal standard of living.

Gifts made for a special purpose clearly do not qualify and it is generally useful to have an established pattern of giving such as monthly or annually. Critically, the source of the gift must be of income and not capital. Income does not retain its character of income indefinitely and unless demonstrated otherwise, HMRC tends to accept income loses its character of income after two years.

If you are already meeting care costs then your regular expenditure will be high but if you consider this heading before such time then it can be a very useful and effective way of passing the surplus income to the children while also reducing the exposure to overall IHT in the long term.

Potentially exempt transfers (PETs)

Some individuals have other assets such as a wide range of investments and rental properties which will provide income. Cashflow planning may suggest affordability to make a gift out of their capital. There is no limit on the value of a capital gift. The value of the gift reduces the donor's estate in full for IHT purposes after the donor has survived seven years from the date the gift is made.

If the donor dies before three years have passed, there is no relief from IHT. If the donor survives three years but less that the full seven years, the position is determined on a sliding scale set out as follows:

Years	**%**
3-4	20%
4-5	40%
5-6	60%
6-7	80%

Discretionary trusts

Some individuals prefer to make gifts into a trust rather than to the children or other individuals directly. It can be a choice between direct control by the individual or by trustees. The trustees own, control and protect the assets of a trust.

On the basis that the trust is discretionary in nature, the trustees will only give a distribution to a beneficiary at the trustees' discretion. In this way, trusts have stood the test of time as a vehicle to both protect and preserve family wealth.

Transfers to a trust

A gift to a trust is a chargeable lifetime transfer and the value transferred must not exceed the value of the available nil rate band for IHT, ie, a maximum £325,000 in order that no IHT arises on the value transferred at the time of transfer. If the sum transferred represents normal expenditure out of income then it may even be an exempt gift.

If this sort of strategy starts early enough then a transfer up to the nil rate band can be made every seven years into a trust. Anyone thinking of a trust needs to be aware of the tax position for the trustees and the beneficiaries upon receipt of a distribution. In the right circumstances, trusts can play a very effective part in overall IHT planning.

Pension planning

From April 2015, if an individual dies before the age of 75, they can give their defined contribution fund to anyone as a lump sum and there is no tax payable by the recipient or the deceased. If the individual dies after the age of 75, his nominated beneficiary will pay tax at his marginal rate of income tax.

For many people now, leaving the pension to the next generation is a very effective way of passing on wealth in a highly tax efficient way. It also gives some comfort that there is a pot of wealth earmarked and destined for the children.

The family house

The problem with the home is lack of flexibility. It is not easy to give away a piece of it only. A gift of any asset must be unconditional and this requires that no benefit beyond a de minimis is retained in the asset given away.

The problem with the home is lack of flexibility. It is not easy to give away a piece of it only

If an individual gives the whole of their house to their children but continues to occupy it this is a gift with reservation of benefit and is not effective for IHT purposes. It is technically possible to give away an interest in it and continue to occupy the whole by virtue of the part retained but the matter of giving away an interest in the property in which you live brings into consideration many other issues.

Once ownership is shared, disputes can arise between the owners and this can lead to loss of control of the asset.

If a person 'downsizes' and therefore replaces one home with a smaller one, this should release liquidity which can release funds available to meet the costs of care and potentially also further planning opportunities. The new residence nil-rate band will help where the overall estate value is less than £2m.

If the property in question is one that has been in the family a long time and the family wish to retain it then they can consider whether the children can acquire it from the parents. In general, it is lack of affordability on the part of the children which restricts this in practice but for some families this presents a real opportunity.

There is no single solution but a wide range of possibilities.

In practice, the following key questions will help shape the long term plan:

1. Has the individual got sufficient income to meet his own needs now and over the long term?
2. Who will benefit from the estate on death including charities?
3. Is there a pension that can be passed to the children?
4. Are there any assets that are not charged to IHT, such as business property relief (BPR) qualifying assets?
5. Can the individual afford to make lifetime gifts to individuals or charities?
6. Should some assets be protected and governed with trustees?

It is essential to start planning early and constantly review the position as time passes and needs change. Cashflow modelling together with tailored estate tax planning for each person based on their individual needs and long-term objectives can identify resources available to meet expenditure over time while also securing succession of some wealth to the family as desired.

About the author

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