



Inheritance tax an issue for an increasing number of people

As a concession to the LibDems, the Conservatives have shelved their plans to raise the inheritance tax (IHT) threshold to £1 million, and the new government has made clear that it is unlikely to make any radical changes to inheritance tax.

As a result, the nil rate band may well remain at £650,000 for married couples (£325,000 for single people) until the end of the 2014/15 tax year, as announced by the previous government in its last Budget. With house prices showing signs of recovery and markets still well above their 2008 lows, even people with a relatively modest family home and a few investments are realising that there will be tax to pay on their estate should they die. Any amount above the threshold is taxed at 40%.

Yet there are a number of ways people can reduce what is still largely a voluntary tax, despite the tightening up of various legislative loopholes.

Clearly the best way to ensure that wealth cascades down the generations, rather than into the country's coffers, is to pass on assets above the nil rate band while you are alive and, having done so, live for a further seven years. However, for most people this is not a practical option – understandably they are keen to remain living in their home and to maintain their income at a comfortable level.

Remove assets from an estate AND take income

There are other options. For instance clients can transfer significant assets into a Discounted Gift Trust, held for the benefit of their chosen beneficiaries, while retaining the right to benefit from an "income" from the trust for the rest of their life.

Importantly, part of the amount transferred will be regarded as a gift for IHT purposes (either a Chargeable Lifetime Transfer or a Potentially Exempt Transfer, depending on the version of the trust used) and will therefore fall outside the estate after seven years. The remainder, known as the retained right, falls outside the estate immediately.

How is the discount calculated?

The discount is effectively the open market value of the settlor's retained interest. This is influenced by a number of factors:

The settlor's age: the younger the settlor, the longer the income may need to continue, the greater the amount the settlor will expect to receive back from the trust and therefore the higher the discount. HMRC will not accept a discount of a settlor aged 90 or older.

The settlor's gender: statistically, women are likely to live longer than men and therefore likely to receive more back than a man the same age.

The settlor's health: if the settlor is in poor health, he or she might be expected to die sooner than a healthy person the same age and therefore receive fewer payments, reducing the level of discount.

Withdrawal level: the higher the amount withdrawn, the greater the amount the settlor will expect to receive back and therefore the greater the discount.

Prevailing interest rates*: the fund will be invested and part of the settlor's payments will come from future growth. When interest rates are high it is assumed that a greater percentage of the settlor's income will come from growth and therefore a smaller amount of capital will be needed, which means that the discount will be lower. When interest rates are low (as at present) less of the income will come from growth so the discount is higher.

* The capital taxes office declared rate of interest is used, 5.25% as at April 2010.

How does it work?

A Discounted Gift Trust is established either by investing directly into an investment bond, which is then placed in trust, or by placing cash into a trust for trustees to invest into the bond.

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The person setting up the trust, known as the settlor, is entitled to a series of regular payments, of a specified amount, determined at outset. The payments can be for any amount but it is usual for them to equate to 5% a year of the original amount transferred, as 5% can be withdrawn from a bond each year on a tax deferred basis.

The retained right is the amount the settlor can expect to receive in regular payments from the bond during his or her lifetime, as calculated by actuaries. As this is not a gift for IHT purposes it falls outside their estate immediately.

The remainder of the amount transferred is held in trust – either a discretionary or absolute trust – for the benefit of the settlor's heirs. This element, known as the discounted gift (ie the retained right has been deducted from it), is either a Potentially Exempt Transfer (ie falls outside the estate if the settlor survives for seven years from the date the trust was set up), or a Chargeable Lifetime Transfer, depending on the type of trust used. If it is a Chargeable Lifetime Transfer, the discounted gift may be subject to lifetime IHT, currently charged at 20% if it exceeds the client's available nil rate band.

Tax-deferred income

Payments from a Discounted Gift Trust are regarded as a return of capital. This means that up to 5% of the original amount invested can be withdrawn each year without an immediately liability to income tax. This can continue for up to 20 years (ie when 100% of the original capital has been withdrawn). Once the full amount has been repaid in this way, each further income payment will be considered to be a chargeable event, creating a potential income tax liability. Payments from a Discounted Gift Trust are not taken into account when calculating income for "age allowance" purposes, except if the trust has been running for more than 20 years.

Investment performance

As the regular payments are made from capital the underlying investments need to grow at an average of 5% a year to maintain the value of the fund.

Many investment bonds offer a wide choice of underlying investments from which to choose, enabling investors to achieve a balanced portfolio that is in line with their attitude to risk.

Finally, it is important to remember that Discounted Gift Trusts are designed for clients who want to reduce their IHT liability but need income. If they don't spend their income then it will simply accumulate in their estate again, negating the objective of the trust.

Example

Bob, aged 62 and in good health, places £300,000 in a Discounted Gift Trust. He required an "income" of £15,000 a year, 5% of this amount.

Underwriters confirm his discount (retained right) as 56.64%, which equates to £169,908 of the amount placed in trust, and the amount given to the trust as £130,092.

Provided he survives for seven years the gift will fall outside his estate. The retained right is deemed to have left his estate immediately.

Bob's income of £15,000 a year continues for the rest of his life, providing enough money remains in the trust.

Despite the closing of loopholes, it is still possible to preserve wealth accumulated over the years and ensure more of it cascades down the generations.

LighthouseCarrwood advisers are experienced in advising on IHT mitigation including:

- how much you can give away tax-free, when, and the rules on such gifts
- ways of reducing your capital while maintaining your income
- the impact of funding long-term care
- how you can release capital from the family home and continue to live in it

LighthouseCarrwood is one of the UK's leading providers of financial planning services to professional practices. We would be delighted to work with you to help your clients reduce their tax liabilities. To discuss how we could work with your firm in a way that suits you and benefits your clients and your business, please contact:

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