Inheritance Tax Planning 2020/2021

Coronavirus has many people reflecting on their own mortality. So if you have more time on your hands during the lockdown, planning your estate may be a wise way to spend it.

Benjamin Franklin observed there are only two certainties in life: death and taxes, and nothing marries the two together quite like inheritance tax. It may have a bad reputation, but as we explore below, paying inheritance tax is far from being a certainty in the UK in 2020.

What is inheritance tax?
When you die, the assets that you leave behind are known as your estate – things like your possessions, savings and investments, and property.

If your estate is valued above a certain threshold, inheritance tax may be charged on it. The normal rate of inheritance tax is 40% in 2020, as it has been for many years. With the average house price alone in the UK being about £230,000, you'd be forgiven for thinking the Treasury will make some serious gains from your demise. But there are wide-ranging mitigations that may protect a good deal of your estate from inheritance tax.

Indeed, many people with an estate that exceeds the threshold end up with no inheritance tax liability at all. Some of these mitigations kick in automatically, while others require planning. So let's take a look at how your estate is protected from inheritance tax, and specific actions you can take to protect it further – all perfectly legally.

Reducing your liability by default
Importantly, anything left to your spouse or civil partner is not subject to inheritance tax. The same applies for assets passed on to a charity or community amateur sports club. You may also already know that we are each given a threshold, up to which our estate has no inheritance tax liability. In 2020/21 this is £325,000.

If your estate is worth less than this, you'll have zero inheritance tax to pay and if you have more than £325,000, only the excess would be subject to inheritance tax. Better still, if you are married or in a civil partnership, you can effectively pool this allowance with your partner, removing the first £650,000 from the scope of inheritance tax.

Even better, since 2015, there has been an additional provision to protect the estates of parents and grandparents when passing on a main residence to children or grandchildren. It is called the residence nil-rate band or family home allowance and in 2020/21 it is worth £175,000 each (for estates of up to £2 million).

Again, it can be pooled across spouses. So, if a main residence is involved and you are married or in a civil partnership, you may be looking at an inheritance tax exemption of £1m.

Proactive steps to reduce inheritance tax
If your estate still faces a liability after the above provisions are accounted for, there are a number of ways to further reduce or potentially eliminate inheritance tax liability. Chief among these is giving gifts while you are still alive.

HMRC classes a gift as anything which has a value. Most obviously in this context it may be cash, but it could also include possessions or property. Additionally, the definition can catch selling something at less than market value, with the difference counting as a gift in HMRC's eyes. With this in mind, there are a series of small gifts you can give away each tax year without any inheritance tax implications on death.

You might even see them as allowances, and work them as hard as you can, much as you would do your annual ISA contributions.

They are:

- Small gifts of up to £250 per person, per tax year
- Normal gifts that come from your income rather than savings, which don't reduce your standard of living
- Money which assists with living costs for another person, like a child under the age of 18 or someone elderly
- Political or charitable donations
- Wedding (or civil ceremony) gifts valued at £1,000 per person, £2,500 per grandchild, and £5,000 per child.

Depending on your circumstances, these may all seem relatively small fry, so you will be pleased to know that there is a more comprehensive option, but it does require additional planning.

The seven-year rule

It's known as the seven-year rule, and in simple terms it is as follows: if you survive seven years after the giving of a gift - known as a potentially exempt transfer - regardless of value, then that gift falls out of the scope of inheritance tax.

Even if you were not to survive that long, you may still pay less inheritance tax should there be liability. The full 40% tax rate stands for the first three years after the gift and then a sliding scale is activated.

Survive three to four years and 32% is charged, four to five years and it drops to 24%, five to six years and it is 16%, and between six and seven years it is just 8%. A key point to keep in mind is that it must be a genuine gift, given unconditionally without reservation.

An obvious example of a gift that would fail this test is if parents gave their house, or a portion of it, to their children, but continued to live in it as if it were their own. This would not qualify as a gift, although the residence nil-rate band may come into play to prevent inheritance tax being due.It would be wise to leave a paper trail confirming the nature of the gift and the date it was made.

As you may imagine, this can be a very effective way to lower inheritance tax liability - as long as it is properly planned and done correctly.

Special situations to be aware of

The above rules will cover the vast majority of cases. However, as with most tax planning there are a number of outlying scenarios which could positively or negatively affect your position. We'll touch on some of the main issues to paint a picture of what we mean, but you may wish to seek further advice if relevant to you.

One way to achieve a small reduction in the tax rate is to leave 10% or more of your estate to charity. This reduces the headline rate of inheritance tax on the remainder of the estate from 40% to 36%.

Gifting to a trust is a whole other area of inheritance tax planning, and not one we will explore here. Ask us for professional advice if you wish to explore your options. There are some job roles classified as risky, which may earn an exemption if active service causes or hastens death - armed forces and firefighting roles for instance.

Owning business assets, agricultural land that is part of a working farm or separate woodland, may be a factor which earns full or partial exemption.

Three final warnings: ensure you keep your will up to date; your situation may become more complicated if you are not domiciled in the UK; and if you own property jointly with someone who is not your spouse, do not take for granted what will happen to the property if one of you dies. Some nasty inheritance tax liabilities could emerge with that last pearl of wisdom where they were not expected.

Rounding up

As you can see, looking past the headline figure of a 40% inheritance tax, there are plenty of ways in which you can eliminate or significantly reduce the liability imposed on your estate, and ultimately your loved ones.

Some require no action from you, while others require planning.
Usually, no one has to pay tax on the first £325,000 of their estate, and any of the following has the potential to add further protection:

- Leaving your estate to a spouse or civil partner
- Passing on a primary residence to children or grandchildren
- Making charitable or political donations
- Giving gifts within prescribed rules
- Other special situations.

If you would like to discuss Inheritance Tax Planning with a member of our team, please contact us on 020 7330 0000.

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