Inheritance tax planning report

Prepared for Mary & Peter Parker

Contents

1. Your circumstances **3**

2. Objectives **3**

Attitude to risk *3*
Planning assumptions *3*
Other assumptions *3*

3. Inheritance tax on Katy's death **4**

4. Inheritance tax planning **5**

Estimate of potential IHT liability on Mary & Peter's death *5*
Recommendations *6*
Revised estimate of potential IHT liability if recommendations implemented *7*

5. Investment **8**

Childrens investments *8*
Investment of the discretionary trust *8*
Personal investments *8*

6. Other issues to consider **9**

7. Action needed **9**

Mary & Peter *9*
Financial Planner *9*

1. Your circumstances

1. Mary's mother, Katy, has recently passed away leaving her home valued at £725,000 and £75,000 in cash. The house has been sold for £648,000 with sale expenses of £8,000. Katy's will left £10,000 to each of your three children with the remaining estate to Mary. Mary's father left £1,000 to each of your children and £100,000 to Mary with the residue passing to Katy upon his death in March 2003.

2. You have combined gross earnings of £65,000 and net current expenditure of £38,000 per annum.

3. Your home is worth £450,000 with an interest only mortgage of £255,000. You have no other debts.

4. You have savings of £20,000 and an equity ISA worth £10,000. Mary's pension fund is worth £72,000 and Peter's £60,000.

2. Objectives

1. You are concerned about the inheritance tax IHT) that is due on Katy's death and also the potential IHT liability that would be incurred if you were both to die prematurely. You therefore wish to minimise any IHT if possible.

2. You also wish to invest your inheritance in the most effective manner bearing in mind your overall financial circumstances.

3. You also wish to ensure that your daughters can only access their investments when they reach age 18.

Attitude to risk

You are relatively inexperienced investors, but understand the need for some element of investment risk in order to secure your long-term future. You therefore feel comfortable investing up to 50% of your capital into equities.

Planning assumptions

Rate of inflation	**2.5% per annum**
Rate of investment growth	**5.0% per annum**

This rate of growth is net of all charges and assumes a 50% weighting to equities for your long-term investments. The 5% is before the impact of inflation.

Other assumptions

- Both of you are resident, ordinarily resident and domiciled in England and Wales for tax purposes.
- Mary's parents were both domiciled in England and Wales for inheritance tax purposes.
- Katy passed away in the tax year 2009/2010 i.e. after 5th April 2009 – please let me know the date of death as specified on the death certificate.
- Funeral expenses of £3,000 are incurred for Katy's funeral and these are an allowable deduction for inheritance tax purposes.
- That Katy made no gifts in the seven years prior to her death.

3. Inheritance tax on Katy's death

Mary's father Donald did not utilise his full nil-rate band on death. The specific bequests totalled £103,000 with the remaining estate passing to Mary under the spouse's exemption. The nil-rate band was £250,000 in 2002/03 when Donald passed away. This means that Donald's unused nil-rate band is £250,000 - £103,000 which equals £147,000. This equates to 58.8% of the nil-rate band and this percentage is then applied to the nil-rate band level applicable on Katy's death. The nil-rate band is £325,000 for 2009/10. Therefore, the transferable nil-rate band available for Katy is £325,000 x 58.8% which is £191,100.

Estimate of inheritance tax due

Assets		
House	£	648,000
Cash	£	75,000
Gross Estate	**£**	**723,000**
Less: liabilities		
Debts	£	-
Funeral expenses	£	3,000
Less: nil rate band	£	325,000
Less: nil rate band unused on Donald's death	£	191,100
Taxable estate	**£**	**203,900**
Tax due at 40%	**£**	**81,560**
Less cost of house sale	£	8,000
Net of IHT estate	**£**	**630,440**

The main asset of the estate is Mary's house which was valued at £725,000 at the date of death. However, the sale price can be substituted for IHT calculation purposes.

The estimated inheritance tax due on Katy's estate is **£81,560**. After inheritance tax, Katy's estate totals £630,440. Her will provides for specific bequests of £10,000 to each of your children, with Mary inheriting the residue of **£600,440**.

4. Inheritance tax planning

Estimate of potential IHT liability on Mary & Peter's death

Assets		
House	£	450,000
Joint savings account	£	5,000
Mary's Inheritance	£	600,440
Mary's ISA	£	10,000
National Savings Certificates	£	15,000
Gross Estate	**£**	**1,080,440**
Less: liabilities		
Mortgage	£	255,000
Funeral expenses	£	6,000
Less: nil rate band	£	325,000
Less: nil rate band	£	325,000
Taxable estate	**£**	**169,440**
Tax due at 40%	**£**	**67,776**
Net of IHT estate	**£**	**751,664**
Peter's pension fund	£	60,000
Mary's pension fund	£	72,000
Mary's Death In service	£	240,000
Net estate plus pension assets	**£**	**1,123,664**

- You can see that the current potential IHT liability if you were both to pass away at this stage would be **£67,776**. In fact, quick succession relief (QSR) could reduce or even negate this liability in certain circumstances.
- QSR exists to reduce the burden of double taxation and would apply if Mary were to pass away in the five years following Katy's death and leave an estate chargeable to IHT. Thus if Mary was to predecease Peter and leave her entire estate to him, no QSR would be available, as the spouses exemption would mean no IHT was payable in any event.
- The maximum QSR is £71,075 in year one reducing by twenty percent each year to zero after five years.
- I have excluded your combined pension values of £132,000 and Mary's death in service of £240,000 as these should be paid out free of IHT if under trust or as long as an irrevocable nomination of death benefit has not been made. If this is not the case, then the potential IHT liability would increase by £148,800 (£372,000 x 40%).

Recommendations

1. You should consult a solicitor to draw up suitable wills and LPAs (lasting power of attorney). This will ensure that your affairs will be organised in accordance with your wishes in the event of your death or on earlier serious incapacity.

2. You should also establish pilot trusts via the solicitor to receive the death benefits from your pension funds in the event of death prior to taking pension benefits. This saves no IHT on first death, as pension death benefits are generally free of IHT as long as an irrevocable nomination of benefits has not been made. However, the pilot trust ensures that the death benefit value (which should equal the pension fund value) will not fall into the surviving spouse's estate for IHT purposes on their death, and yet the surviving spouse can retain access to the entire pilot trust capital. Hopefully these trusts will never be needed and they will effectively remain dormant unless required due to premature death prior to drawing pension benefits.

3. Mary should arrange a deed of variation (DOV) of her mother's will to establish a discretionary trust with £200,000 of her inheritance. This needs to be completed within two years of Katy's death but I would recommend you organise this with the solicitor immediately. This is the most important element of my IHT planning recommendations. This action creates a much more beneficial arrangement than if Mary were to establish the same form of trust herself. With a discretionary trust established by a DOV, you can be potential beneficiaries of the trust and receive the full value of the trust if necessary, yet the value of the trust will never form part of your taxable estates. This could not happen with a trust established by Mary because of the anti-avoidance rules which effectively penalise a person transferring assets into trust whilst remaining a beneficiary under the trust.

4. You should repay your outstanding mortgage amount of £255,000 as long as no early repayment penalties apply. This will not only provide peace of mind but reduce your regular outgoings whilst also providing a 'risk-free' investment as you would effectively earn a net return of the mortgage interest rate.

5. You are both young and therefore I do not feel that you should make outright gifts or further transfers into trust at this stage. We can review your financial situation each year and reconsider the IHT situation in light of your developing finances.

6. You should consider increasing your pension contributions to not only provide for your future, but also as pensions are a very IHT efficient environment with any fund value payable free from IHT in the event of death before drawing benefits.

Revised estimate of potential IHT liability if recommendations implemented

Assets		
House	£	450,000
Joint savings account	£	5,000
Mary's Inheritance	£	145,440
Mary's ISA	£	10,000
National Savings Certificates	£	15,000
Gross Estate	**£**	**625,440**
Less: liabilities		
Mortgage	£	-
Funeral expenses	£	6,000
Less: nil rate band	£	325,000
Less: nil rate band	£	325,000
Taxable estate	**-£**	**30,560**
Tax due at 40%	**£**	**-**
Net of IHT estate	**£**	**619,440**
Peter's pension fund	£	60,000
Mary's pension fund	£	72,000
Mary's Death In service	£	240,000
Discretionary Trust	£	200,000
Net estate plus pension assets	**£**	**1,191,440**

Observations

You can see that implementing my recommendations reduces the combined value of your gross estate to £625,440 which is approximately £25,000 less than your combined nil-rate bands. This means that there would be no IHT liability if you were both to pass away in the near future. However your estates will increase in value with house price inflation and investment growth along with any additional savings that you make.

The discretionary trust established by the deed of variation could be funded with up to the entire value of your inheritance from Katy i.e. £600,440. However, you need to balance the potential IHT saving with retaining enough capital to achieve your other financial goals. I have only recommended that £200,000 is transferred into trust, but you may feel that a higher amount is warranted.

Discretionary trusts are subject to ten year periodic and exit charges when capital leaves the trust. The maximum ten year charge is 6% on the trust value in excess of the nil-rate band applicable at the time (£325,000 for 2009/10). If the trust value does not exceed the nil-rate band then no periodic charge is applicable. If there has been no periodic charge at the previous ten-year point then no exit charge is payable over the next ten years.

The table below demonstrates that with an initial trust investment of £200,000 no periodic or exit charges will be applicable until the thirty year mark (assuming net investment growth of 5% and inflation of 2.5%).

Trust value	Nil rate band	Year	10 year tax charge	Present Value of Trust fund
£ 325,779	£ 416,027	10	£ -	£ 254,498
£ 530,660	£ 532,550	20	£ -	£ 323,846
£ 864,388	£ 681,709	30	£ 10,961	£ 412,091

5. Investment

Childrens investments

Your children previously received gifts from Donald and are also due to receive £10,000 each under Katy's will. As your children are still minors you will hold these assets as a bare trustee for their benefit until they become 18, when they will become legally entitled to possession of the assets. This means an investment timescale ranging from 4 to 7 years. This is a short to medium-term timescale and would suggest avoiding investments such as equities which can exhibit large fluctuations in capital values. If you do not envisage your children spending the full value of their holdings at 18 it may be suitable to invest in longer term investments that should provide greater growth.

Investment of the discretionary trust

The idea of the discretionary trust is to provide a long-term structure to hold the family's wealth. Therefore I would not envisage accessing the capital for many years and the investment strategy would be for long-term capital growth.

I would recommend the use of an onshore life assurance bond structure to hold the trust investments. This provides the following benefits;

- Ease of administration as no trust tax return will need to be completed each year.
- It is a tax efficient structure as the tax in the underlying life assurance funds will be no higher than basic rate, and with careful organization it will be possible to assign segments of the bond to beneficiaries who will not incur a higher rate tax charge on encashment. This makes use of the deferral benefits of life assurance and is useful where beneficiaries are only basic rate taxpayers. This makes the strategy very appealing with Peter's tax status.
- A wide range of collective investments can be held in the bond in the similar manner as I would recommend for your personal investment holdings. This provides excellent diversification and cost savings.

Personal investments

My recommendations leave an inheritance of £145,440 from Katy's estate. When combined with your existing savings this totals £175,440.

It is always important to retain an emergency fund and short-term portfolio which can be used to meet expected and unexpected expenditure requirements. I think you should retain an amount in deposit based investments that will meet your expenditure should Mary lose her job. I think you should retain one year's expenditure of £38,000 in addition to your emergency fund – say the £5000 in your savings account. This leaves £132,000 available for the long-term portfolio, of which you are happy to invest 50% into equities for longer term growth. The remaining 50% will be in diversifying lower risk investments. Your long-term portfolio should be viewed as a ten year investment although it is possible to encash elements of it at any stage. With a 50% equity weighting I have assumed a net of charges and tax growth rate of 5% per annum or 2.5% above inflation. This seems a realistic

growth rate and if this is achieved it would turn the £132,000 into approximately £250,000 in 27 years time when you are both age 65 (this is a real return so this should equate to having £250,000 in today's terms).

You can both invest £7,200 into an ISA in this tax year which I recommend that you both do. The other investments should be held in Peter's name as he is a non-taxpayer and thus the investments will be subject to a maximum of basic rate tax at 20% or maybe less. The joint savings account of £5,000 pays a very low rate of interest so this can be retained as a joint account for ease of operation.

6. Other issues to consider

- You should give some thought to the financial implications for your children and surviving partner if one of you were to pass away prematurely. Mary has death in service life cover of £240,000 from her current employment. Peter has no life cover. Although you will have your investments and the discretionary trust monies to utilise, it maybe worth considering additional life cover to protect yourselves until your children are no longer financially dependent on you. This would translate to ten year cover to take you up until your youngest child is 21. This should not prove too expensive and I can provide costings if you would like.

- You need to consider at what age you would like to retire at and the level of annual expenditure that you envisage. I can then provide a lifetime cashflow analysis which will help you understand whether you will be on target to meet your overall financial objectives. It is imperative that this is reviewed as your situation changes.

7. Action needed

Mary & Peter

Deed of variation to Katy's will, wills, LPAs and pilot trusts: I can recommend a suitable solicitor to help you with these points. It will probably be best that we have a combined meeting to ensure that our advice works together in a coherent manner. Please let me know how you wish to proceed.

Children's investments: If you can provide the details of their current holdings I will review the asset allocation and provide my recommendations.

Pensions: Again, if you can provide details of your current holdings I will review the asset and fund allocations and provide my recommendations.

Financial Planner

Discretionary Trust: Suggested investment portfolio and life assurance bond recommendations.

Reviews: Annually in February so we can take advantage of the tax year-end if necessary.

I will contact you in two weeks to discuss this report in more detail and how you would like to proceed.

Total words 2496