



The benefits of simple IHT planning

Both Paul and Richard live in a country very much like England but there is no inflation and Inheritance Tax rules never change! Both of their families have similar circumstances. Their stories show the possible benefits from taking early advice on simple IHT planning.

Paul's Story

Twenty years ago, on Paul's 21st birthday, Paul's grandparents sat him down and explained the family estate to him.

The family estate was composed of a £650,000 house which was to be left to the housekeeper, and £2,000,000 of investments, out of which inheritance tax would have to be paid. This is left first to the surviving grandparent, then to Paul's mother and finally to Paul himself.

On top of this the grandparents were saving nearly £30,000 from their income each year.

Paul, being that sort of a boy, worked out that if the grandparents died in a car accident with his mum he would get £1,200,000. (Fig 1.)

However, this isn't a morbid story and in fact Paul's grandfather lived another eight years, long enough to see two great grandchildren born. Paul's grandmother lived a further two years and on her death, left the estate to Paul's mother as planned. In fact, the savings turned out to have been rather more than anticipated and the overall estate was £3,150,000. The tax worked out as follows. (Fig 2.)

Fig 1.

Estate	£2,650,000
Less IHT nil rate bands (2 x £325,000)	£650,000
Chargeable to IHT	£2,000,000
Tax at 40%	£800,000
Less Gift to housekeeper	£650,000
Balance to Paul	<u>£1,200,000</u>

Fig 2.	
Estate	£3,150,000
Less IHT nil rate bands (2 x £325,000)	£650,000
Chargeable to IHT	£2,500,000
Tax at 40%	£1,000,000
Less Gift to housekeeper	£650,000
Balance to Paul's mother	<u>£1,500,000</u>

As I said before this is not a morbid story and Paul's mother, who had been a single parent until now, met the love of her life and got married soon after. Three years later though, she was divorced, and whilst she kept her original home and £1,000,000 of the estate, the divorce cost her £500,000.

£1,325,000 and, following the family tradition, left her £325,000 house to her friend. Paul has just calculated the estate as follows. (Fig 3.)

Whilst not one to carp about these things, Paul realises that, of an estate worth £2,500,000 at its peak (net of grandparents' gift to their housekeeper), £1,400,000 IHT has been paid and £500,000 has gone to his ex-step-father; so he gets 24%, the government gets 56%, and the ex-step-father gets 20%. Even without the step father these ratios would have been just 36% for Paul and 64% for the government.

Fig 3.

Estate	£1,325,000
Less IHT nil rate band	£325,000
Chargeable to IHT	£1,000,000
Tax at 40%	£400,000
Less Gift to friend	£325,000
Balance to Paul	<u>£600,000</u>

Richard's Story

Twenty years ago, Richard went with his mother and grandparents to see a firm of Chartered Accountants called Hornbeak Accountancy Services. They worked out that Richard's grandparents also had an estate of about £2,650,000. The grandparents had wills which left a total of £650,000 to distant family members in specific gifts, with the remaining estate left first to each other, then to Richard's mother and finally to Richard.

The grandparents were also saving about £30,000 of their income per year.

On investigation Hornbeak found the following:

- The grandparents were very worried about Richard getting in with the wrong type of woman who would divorce him and take half of the family estate.
- The grandparents had an exaggerated fear of residential care fees.
- The estate included a £250,000 property rented out for £10,000 per annum, in grandfathers' name.
- The estate included a 1950's stamp collection which had belonged to grandmother's father, was of no interest to the grandparents, but was willed to Richard's distant cousin who is an avid collector. The collection was valued at £150,000.

Hornbeak recommended that:

1. Whilst Hornbeak's first concern must be the (financial) wellbeing of the grandparents, the family is able to undertake some substantial Inheritance Tax planning.
2. Grandmother is to gift the stamp collection to the cousin immediately – provided she lives seven years it falls out of the estate and saves £60,000 of IHT! On the other hand, it appears that the grandparents derive no benefit from continuing ownership.
3. The investment property is put into a discretionary trust for the benefit of Richard's mother and descendants. Again, this is within the £325,000 limit for potentially exempt transfers. If grandfather survives seven years the gift falls out of the estate and saves £100,000 of IHT. The income transferred to the beneficiaries also reduces the growth in the estate and in ten years time will save a further £40,000 of IHT. The trust also offers protection against divorce.
4. Whilst it is natural for parents to leave their estate to their immediate children, sometimes this does not make financial sense. By the time they die their children may already be in late middle age, with luck they have successful careers, have paid off their mortgage, have savings and are looking forward to their own prosperous retirement. In contrast, the grandchildren are probably suffering from university fees, trying to find the deposit for their first house and may be starting families of their own. Where these circumstances pertain it can be better to "Generation Skip". This also avoids the potential double taxation charge that hit Paul's family so hard. Richard's grandparents change their wills and leave £250,000 directly to Richard and put a further £250,000 into the trust that they have set up for the investment property.
5. Whilst having sufficient capital to meet foreseeable care costs makes sense, some people become overly concerned about this. Richard's grandparents have retirement income of £60,000 after tax (of which they were saving £30,000). Even after putting the investment property into trust they have an income of about £1,000 per week which should be enough to meet most care costs without even dipping into capital. However, the grandparents choose to purchase a policy which will pay out if they have to pay for residential care, adding another layer of protection to the family estate.
6. Finally, the partner at Hornbeak was rather rude about the limitation on annual gifts out of capital. The grandparents would be saving £20,000 per year out of income, even after gifting the investment property. He therefore recommended that they begin immediately gifting some of that surplus income to their descendants. They agree that as Richard is trying to pay off his university debt and buy a new house, they will pay him £1,000 per month to help out. Shortly after his first child is born, they start to pay a further £8,000 per annum into the discretionary trust.

Like Paul's grandparents, Richard's lived for eight and ten years and although their family estate was also

£3,150,000, the situation was very different. (Fig 4.)

At this stage, Richard's grandparents estate can be tracked as follows:

Tax	£720,000
Family Trust	£580,000
Richard	£470,000
Richard's mother	£730,000
Total estate value	£2,500,000

In the next few years Richard's family was struck by a whirlwind romance, a lightening marriage, a couple of stormy years and a messy divorce. In this case £230,000 (of £730,000) ended up with the ex-husband.

So when Richard's mother died a few weeks ago, her taxable estate was £500,000 (her £325,000 house was just covered by the nil rate band) and so she (or rather Richard) had £200,000 of IHT to pay, leaving £300,000 for Richard.

Fig 4.

Stamp collection already gifted to Cousin	£150,000
Property already gifted into Trust	£250,000
Rental income from trust paid to Richard	£100,000
Gifts out of income to Richard	£120,000
Gifts out of income to Trust	£80,000
Total funds outside of IHT	£700,000

Estate subject to IHT	£2,450,000
Less nil rate bands (2 x £325,000)	£650,000
Chargeable to IHT	£1,800,000
IHT at 40%	£720,000

Available to beneficiaries	£1,730,000
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Gifted as follows:

To distant family members	£500,000
Richard	£250,000
Trust	£250,000
Richard's mum	£730,000

Conclusion

So to compare the final positions of Paul and Richard (Fig 5):

Fig 5.	Paul's family	Richard's family	Savings
Tax Paid	£1,400,000	£920,000	£480,000
Ex Spouse	£500,000	£230,000	£270,000
Main Character	£600,000	£770,000	
Family Trust		£580,000	

As you can see, just using simple IHT planning tools has helped Richard's family retain an extra 30% of the estate and has protected £580,000 for future generations.

I am sure we could make greater savings using more complex planning so, if you or a family member have net assets exceeding your nil rate band(s), why not call us on 01603 720424 or email us to find out how we can help.

If you think this story would be of interest to a friend or wealthy relative please do not hesitate to pass it on.

DISCLAIMER

Most of the information contained in this Hornbeam Highlights is of necessity greatly oversimplified. We are trying to bring to your attention tax planning and business management opportunities. However, you should not take action based upon this leaflet without obtaining specific professional advice.

Whether you are a client or not, if we can provide further help or advice concerning any of the matters covered here, please do not hesitate to telephone us on (01603) 720424.

