FUSION FINANCIAL UPDATE
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FUSION FINANCIAL

THE IMPORTANCE OF ESTATE PLANNING

How to prepare and protect your estate.

We are all somewhat used to living with economic doom and gloom at present, from sky-high inflation rates to tax rises being splashed across the news headlines. But recent analysis from the Office for Budget Responsibility shows that you may also get stung harder after you are gone.

They estimate that HMRC inheritance tax takings are set to rise to £37 billion cumulatively over the next five years. That's compared to £26.7bn for the previous five years to and including the 2021/22 tax year. The rise will be driven by inflation, and the freezing of the thresholds at which inheritance tax
becomes payable.

This means that more people, and more of their wealth, get drawn into the scope of inheritance tax.

The good news is there are numerous planning strategies for managing inheritance tax liability. With a little savvy planning, many people are able to take themselves out of its scope completely, or at the very least reduce its impact significantly.

INHERITANCE TAX RULES

The standard rate of inheritance tax is 40%, but with careful planning it is possible to significantly reduce your potential IHT exposure thanks to a series of allowances and exemptions.

The most significant of these is your inheritance tax allowance, known as the nil-rate band. This allows the first £325,000 of your estate to be paid free from inheritance tax.

There is an additional nil-rate band for your primary residence of £175,000, if you leave it to direct descendants (including adopted, foster or stepchildren). Your total net estate must be valued at less than £2 million for this to apply. Above this, the additional nil-rate band will be tapered away by £1 for every £2 exceeded.

Furthermore, inheritance tax is not payable on anything left to a spouse or civil partner. Indeed, they can carry over your unused allowances, meaning a married couple (or rather their beneficiaries) enjoy a £650,000 inheritance tax allowance, or £1 million if the primary residence nil-rate bands are also available.

Anything left to charities or community amateur sports clubs is also exempt from inheritance tax.

GIVING GIFTS

Once you understand the above allowances, gift giving is another effective tactic for reducing inheritance tax liability.

There is some smaller scale gifting around weddings (up to £5,000), depending on relation to the married couple; annual gifts (up to £3,000) and small gifts (up to £250 per person per year) which you can use to reduce your liability.

But the bigger opportunity potentially comes from regular gifting, and utilising the seven-year rule.

Normally, if you give money away within seven years of your death and it does not fall within one of the above gift exemptions it is treated as if it remains within your estate for inheritance tax purposes.

However, regular gifting rules say that if you gift money regularly out of your normal income after you have met all your own living costs, there is no limit to how much you can give tax-free.

The seven-year rule for non-income based gifts is a bit more involved. It refers to a taper system where the inheritance tax liability on a gift reduces in the years after you give it.

If you survive for seven years, the liability reduces to zero, no matter the gift's value. The tapering reduces the effective tax rate, as follows:

- Zero to three years – 40%
- Three to four years – 32%
- Four to five years – 24%
- Five to six years – 16%
- Six to seven years – 8%
- Seven or more years – 0%

To qualify, you must give the gift without reservation. This means you have no right over the gift and cannot benefit from it unless you are paying a market value.

So, if you gift a house you cannot live in it unless you were to pay rent. If you gifted a painting, you could not continue to hang it on your wall. If you gifted money, you would have to make clear that it was not a loan which you expected to be repaid.

But other than this, there's no limit. So, as part of a long-term strategy, gifting is a highly effective way to reduce inheritance tax liability.

MAKING A WILL

If understanding how inheritance tax works is one important piece of the puzzle, making a will is another.

While a good gifting strategy can help your estate sidestep inheritance tax while you are still alive, a will can help your estate manage the liability after your death.

It's your opportunity to specify exactly how your estate is apportioned after you die. While the primary driver of this is usually to ensure assets go to the right people, there can be unwelcome tax consequences that are realised if you do not have a will.

If you do not have a will, your estate is subject to intestacy law. This is highly prescribed, and often assets are not distributed how you might imagine. We are focused on estate planning here, so won't go into detail about the family arguments that might arise as a result.

But to illustrate just one consequence of intestacy, your spouse may not automatically get all your estate without a will in place – even if you wanted them to.

Intestacy says that a spouse gets all the personal belongings plus the first £270,000 of the estate. Then, if there are surviving children, the excess of the estate above £270,000 is split - with 50% going to the spouse and 50% to be shared equally amongst the children (including those from previous relationships if applicable).

Because any estate left to a spouse is not subject to inheritance tax, intestacy could yield a tax bill where none needed be due if it diverted assets away from a spouse.

OTHER CONSIDERATIONS

We have already mentioned that anything left to charities is exempt from inheritance tax. It is also possible to pay a reduced rate of 36% inheritance tax on some assets if you leave at least 10% of the net value of your estate to a qualifying charity.

For some people, a life insurance pay-out may be made and become part of their estate. This could then be significantly reduced by inheritance tax. There is a simple way to avoid this, which is by making sure the life insurance policy is written in trust.

Most insurers give you the choice automatically when policies are taken out, so you can check if this was selected. Even if it wasn't, you can put a policy into trust at any time, although you may need professional help.

Finally, consider that pensions can in some cases be passed on to beneficiaries without being subject to inheritance tax. This is not the primary purpose of a pension and they are subject to complex rules, but it may be useful to know for some.