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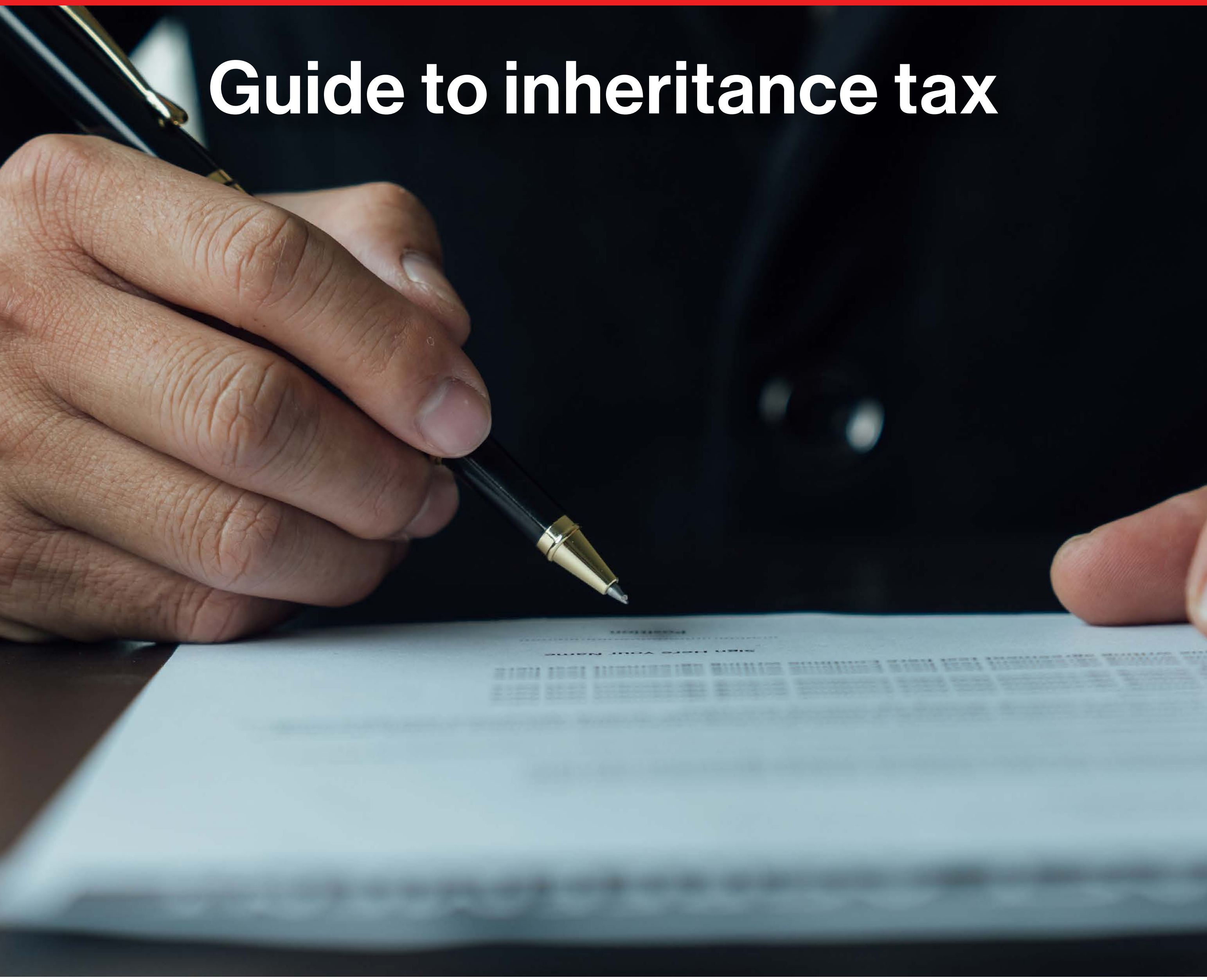
Guide to inheritance tax



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WAY Trustees Limited

IHT: An introduction

With more estates being dragged into the IHT net, the UK is paying more for inheritance than it ever has before

Michael Griffiths, News Editor, MoneyAge

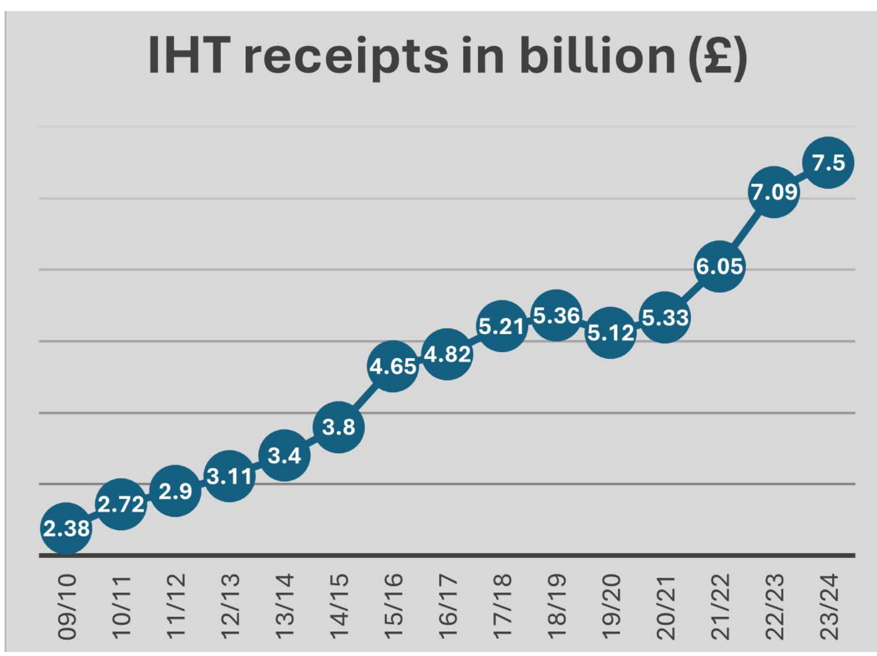
The concept of taxing wealth in the UK dates back centuries but the modern form of inheritance tax (IHT), as it is recognised today, emerged in 1986 when the Government introduced a unified tax system to replace previous death duties.

It was designed to tax the transfer of wealth from deceased individuals to their heirs, in a system built on the idea that large estates and inherited wealth should contribute to state revenues, given the increasing concentration of wealth among the more affluent in society.

However, various thresholds and exemptions have been tinkered with over time, and IHT is ever more becoming a subject of public debate, particularly with regards to its fairness and the impact it has on family businesses and estates.

How does it work?

IHT is a tax on the estate of someone who has died, including all their assets such as property, savings, investments, and valuables. The standard IHT rate is 40%, but this only applies to the value of the estate that exceeds a certain threshold, which is known as the nil rate band.



Graph 1: According to data from HMRC

Since the 2009/10 financial year, the nil rate band has been fixed at £325,000 per person which means that estates worth less than this amount are not subject to IHT. For estates above the threshold, the 40% rate applies to the value above £325,000.

If a person leaves their home to their children or grandchildren, an additional allowance known as the residence nil rate band can apply. This allowance, introduced in 2017/18, can increase the threshold by up to £175,000, depending on the value of the estate and the circumstances.

IHT in 2025

The previous Conservative Government froze both the nil rate band and the residence nil rate band at these levels until 2025/26. Last October, the Labour Government's Budget extended this freeze until 2028/29.

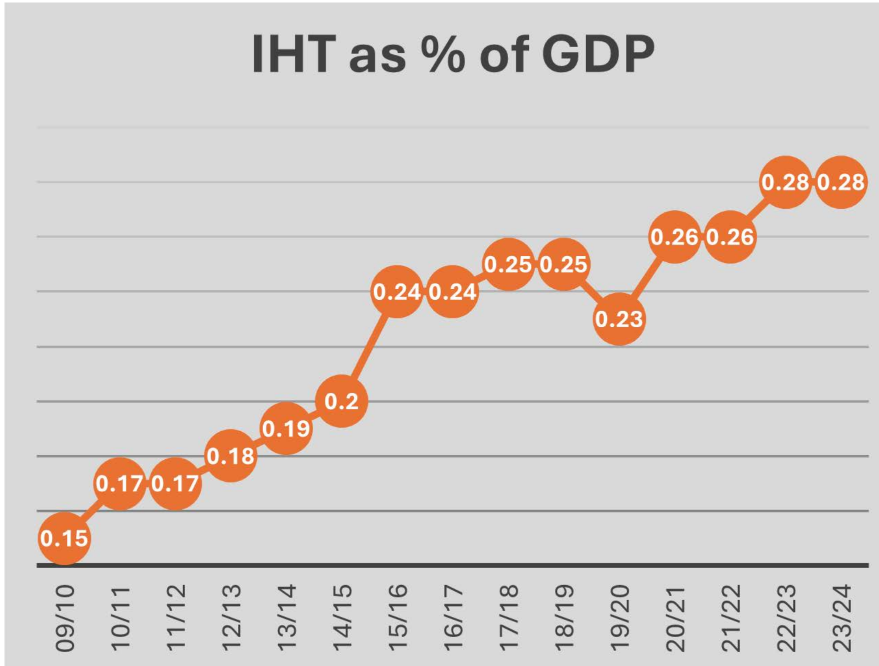
However, this extension has come at a time when the UK is currently paying more in IHT than it ever has done before.

In recent years, as the Bank of England has sought to bring high inflation down from its October 2022 peak of 11.1%, and as the average house price has continued to reach new record highs across the nation, more wealth has been eroded, and more estates are being dragged into the IHT net.

HMRC collected a record £7.5bn from IHT receipts in 2023/24, its highest level to date, and the third year running that the record amount was broken. Receipts in 2024/25 are on course to break this again, and the Office for Budget Responsibility (OBR) also predicts that on the current trajectory, annual IHT receipts will reach as high as £9.8bn by 2028/29.

As a share of the UK's GDP, IHT receipts have also been on a steady rise for more than a decade, mainly as a result of house price growth. According to the OBR, this rise also reflects significant fiscal drag, as the IHT threshold has remained at £325,000 since 2009/10.

When Rachel Reeves, delivering the first Budget by a Labour Chancellor for 14 years, confirmed the freeze on the IHT bands would be extended, she also announced two further significant changes to how IHT would be calculated.



Graph 2: According to data from the OBR

One of these angered farmers, with a new £1m cap introduced from April 2026 on IHT relief for business and for agricultural assets would be capped at £1m.

The other change was to close what Reeves described a "loophole" created by the Conservatives when the lifetime allowance was abolished, by bringing inherited pensions into IHT from April 2027. More on this to come.

But as the fallout from the Budget continues, the public debate intensifies, and inflation continues to erode the value of estates, one constant that hasn't changed in the world of IHT is the need for professional advice...

WAY Trustees Limited

Estate Planning Post 2024 Budget and Beyond

Nathan Blackmore, WAY Trustees, CEO

The recent Budget announcement on 30 October 2024 introduced significant changes to pension inheritance tax (IHT) rules which means there needs to be a greater emphasis on lifetime gifting into Trust and more effective frameworks on first death and less reliance on the spousal exemption.

From 6 April 2027, unused pension funds and death benefits will be included in an individual's estate for IHT purposes with pension scheme administrators required to report and pay IHT to HMRC. The inclusion of pension funds will further increase the number of estates subject to IHT, making this a critical issue for many families. Consequently, immediate financial planning is advised.

Impact on Financial Planners and Clients

For years, pensions have been a primary tool for avoiding IHT, often outpacing their role as retirement funding mechanisms. Wealthy individuals have relied on pensions to pass assets tax-free to their families. However, the changes mean:

- For individuals aged 75 and older, pension death benefits could now face dual taxation: IHT on the total value and Income Tax when beneficiaries withdraw the funds.
- For those under 75, lump sum death benefits exceeding the Lump Sum Death Benefits Allowance (LSDBA) will also be subject to both taxes.

The spousal exemption remains, allowing pension and death benefit transfers to a surviving spouse or civil partner free of IHT. However, these funds will then be included in the spouse's taxable estate.

Next Steps for Pension Savers

For individuals with significant pensions, particularly those exceeding retirement needs, new strategies are crucial:

1. Reduce or Stop Pension Contributions: Cutting back on additional funding may prevent over-accumulation.
2. Utilise Tax-Free Cash: Taking the 25% tax-free lump sum and gifting it to a Flexible Reversionary Interest Trust can make the funds IHT-free after seven years.
3. Gifts from Income: Drawing taxable pension income to fund regular gifts into a similar Trust structure ensures immediate IHT exemption under the "gifts from income" rules.

Additionally, including pensions in the taxable estate has profound implications for estates exceeding £2m. The residential nil rate band (RNRB) tapers away by £1 for every £2 above this threshold, significantly increasing the IHT burden. Estates with high-value pensions and other assets may face compounded tax liabilities, emphasising the importance of proactive planning.

Timing and Planning Considerations

While the changes don't take effect until 2027, planning should start now. The seven-year rule for gifting into Trusts requires prompt action to maximise benefits.

Trusts offer dual advantages: they can mitigate tax and protect family wealth from social impacts like divorce or creditor claims.

Practical Implications of the New Rules

Complexities in HMRC's calculations could introduce challenges. These changes are anticipated to create further delays to the probate process as executors liaise with pension administrators.

Leveraging Trusts for IHT Planning

Flexible Reversionary Trusts offer a valuable solution. These Trusts allow individuals to transfer wealth without losing access to their assets. Gifts into these Trusts are Lifetime Chargeable Transfers, taxed at zero within the nil rate band (NRB), with excess amounts taxed at 20%.

Over time, individuals can continue making gifts as their NRB resets, every seven years. For instance, someone aged 70 could use and recycle their NRB multiple times within their life expectancy, maximising IHT benefits.

Additionally, Trusts accepting regular surplus income under the "gifts from normal expenditure" rules can provide immediate IHT relief. High earners can use these Trusts to shelter surplus income without impacting their standard of living.

What's next?

The new IHT rules significantly impact pension planning, especially for those using pensions as IHT shelters. Trusts – particularly Flexible Reversionary Interest Trusts – offer an effective means of preserving wealth.

Clients with existing IHT liabilities should act now. Making use of lifetime gifting into Trusts to mitigate IHT while protecting and preserving family wealth intergenerationally.

Case Study: Impact of the October 2024 Budget on IHT and RNRB

This case study examines the implications of the changes announced in the recent Budget for Mrs. Smith, a 70-year-old widow, and outlines strategies to mitigate her potential IHT liability.

Pre-Budget Scenario (Up to 5 April 2027)

Mrs. Smith's estate includes the following assets:

- House: £1,000,000
- Deposits: £400,000
- ISA Portfolio: £500,000
- Personal Chattels: £100,000
- Total RNRB-Assessable Estate: £2,000,000
- Inherited SIPP (uncrystallised): £750,000

Her IHT allowances include two Nil Rate Band's (NRB) and two RNRB's, totalling £1,000,000. This reduces her IHT-assessable estate to £1,000,000, leaving an IHT liability of £400,000.

Post-Budget Scenario (From 6 April 2027)

Under the new rules, Mrs. Smith's uncrystallised £750,000 SIPP will be included in her estate for both IHT and RNRB calculations. This increases her RNRB-assessable estate to £2,750,000, exceeding the £2m RNRB taper threshold and eliminating both RNRB's. Consequently, her IHT allowances drop to £650,000, increasing her net IHT-assessable estate to £2,100,000 and her IHT liability to £840,000—a catastrophic rise.

Mitigation Steps

Given her situation, Mrs. Smith can take proactive steps to significantly reduce her estate's IHT liability and restore her RNRB. These strategies involve leveraging Flexible Reversionary Trusts and the "Gifts from Normal Expenditure" exemption.

Step 1: Draw SIPP and Gift into Trust

If Mrs. Smith's husband passed away before age 75, she can withdraw the inherited SIPP tax-free. By systematically drawing down the SIPP and gifting the proceeds via a Flexible Reversionary Trust, she can:

- Use the "Gifts from Normal Expenditure" exemption to gift regular income drawn from the SIPP, which would be immediately IHT-exempt.
- Gift her NRB amount via a Flexible Reversionary Trust, ensuring it becomes IHT-free after seven years.

After Gifts and Trust Settlements:

Retained £100,000 in cash deposits as an immediately accessible 'rainy day fund'.

Used £300,000 from cash deposits and encashed the £500,000 ISA Portfolio (tax-free) to populate the Loan Trust (£469,000) and Flexible Reversionary Trust (£331,000).

- House: £1,000,000
- Deposits: £100,000
- Loan Trust (outstanding loan): £469,000
- Flexible Reversionary Trust (NRB and Annual Gift Exemptions): £331,000
- Personal Chattels: £100,000
- Inherited SIPP (crystallised): £0
- Total RNRB-Assessable Estate: £1,669,000
- IHT Allowances (2 NRBs and 2 RNRBs): £1,000,000

Net IHT-Assessable Estate (after 7 years): £669,000, reducing the IHT liability to £267,600.

Step 2: Recycle NRB

Seven years after gifting her initial NRB into a Flexible Reversionary Trust, Mrs. Smith can recycle her NRB by partially recalling the loan from the Loan Trust and gifting it into a new Flexible Reversionary Trust. This ensures she maximizes her available allowances and continues reducing her estate's taxable value.

No investment or house price growth has been factored into the above example, but they illustrate the point that from 6 April 2027 pensions will revert to being a vehicle to provide income in retirement and not an IHT-planning vehicle (as they have been used by many wealthy individuals).

Key Takeaways

1. Start Early: Planning ahead of the 6 April 2027 deadline is crucial to mitigate IHT liability and preserve RNRBs.
2. Leverage Trusts: Flexible Reversionary Trusts provide a structured way to reduce estate value while maintaining flexibility.
3. Gifts from Normal Expenditure: Regular gifting of income ensures tax efficiency and preserves wealth intergenerationally.
4. Recycle Allowances: Reusing NRBs through Trusts further reduces taxable estate value over time.
5. Flexible Access: If Mrs Smith needs to supplement her retirement income or pay for care, the Trustees can revert money to her from her Flexible Reversionary Trusts. In addition, the Trustees can loan or appoint money to the Beneficiaries at any time.

Conclusion:

By leveraging Trusts and exemptions, Mrs. Smith can effectively restore her RNRB, reduce her estate's IHT liability and secure her family's financial future.

WAY Trustees Limited have been specialising in Flexible Reversionary Trusts for over 20 years, for more information please contact the team on:

***Telephone number:** 01202 890895*
***Email:** info@waytrustees.co.uk*

Conclusion

Professional advice from the likes of WAY Trustees will assist in identifying any potential pitfalls or overlooked opportunities

Michael Griffiths, News Editor, MoneyAge

To conclude, the changes to pension rules for IHT, as set out by Rachel Reeves in the Autumn Budget, will mark an important shift in how individuals can manage and pass on their wealth.

At a time when the UK is paying more IHT than it ever has done before, the pension change coming in two years' time will increase further the number of estates subject to IHT.

While the Chancellor has sought a solution to ensure pension savings are utilised in the most tax-efficient manner, as well as to fix the "£22bn black hole" in public finances she has often alluded to, her changes have also highlighted the ever-increasing complexity of IHT rules.

As WAY Trustees has outlined and demonstrated through Mrs Smith in the case study, the new IHT rules will significantly impact all future financial planning, especially for those using pensions as IHT shelters.

Proactive planning, such as that required for lifetime gifting and setting up a Trust, should start as soon as possible, regardless of the April 2027 horizon. Flexible Reversionary Trusts in particular could mitigate IHT liabilities and protect family wealth.

Given the intricacies of the IHT space, as well as some regularly moving goalposts when it comes to its rules, it is more crucial than ever to seek professional advice from experienced estate planners and tax advisers such as WAY Trustees, who are there to help navigate the various complexities of the IHT landscape.

Working with a professional will ensure that an individual's estate is structured in a way that maximises their potential for tax savings, and that their beneficiaries are best positioned to receive the full benefit of their legacy.

Furthermore, professional advice from the likes of WAY Trustees will assist in identifying any potential pitfalls or overlooked opportunities – ensuring that estate planning is as efficient and effective as possible.

IHT is just one aspect of the tax landscape which is continually evolving, and as the public debate around its fairness continues, there is always the chance that future changes to its rules are not far away. This means there is a constant challenge for estate planners to stay up to date with the latest developments.

The key takeaway from this guide is that when it comes to estate planning, only by taking proactive steps will individuals preserve valuable allowances, reduce the taxable value of their estates, and protect the properties and assets of the generations of the future.

WAY Trustees Limited

PRESERVING FAMILY WEALTH FOR FUTURE GENERATIONS

With over 20 years of experience, WAY Trustees have been helping families with intergenerational tax planning and family wealth preservation

KEY BENEFITS

Wealth Transfer: IHT-efficient Trusts providing flexible access which overcome barriers to lifetime gifting.

Protect Family Assets: Solutions to modern family challenges like divorce.

Peace of Mind: Professional service delivered by a highly skilled and experienced team.

WHY CHOOSE WAY TRUSTEES?

Proven Experience: Trusted by advisers nationwide for 20+ years with over 100 years collective trust industry knowledge.

Client Retention: Long-term planning solutions to assist the intergenerational transition of wealth.

Better Client Outcomes: Tailored to meet the individual needs of the family.

STAY AHEAD WITH A MASTERCLASS

Boost Your IHT Expertise: Refresh your understanding of IHT and stay ahead of the curve.

Prepare for the Future: Gain insights into the upcoming 2027 pension rule changes and their implications.

Tailored Face-to-Face Learning: Personalised sessions designed to meet your business and client needs.

CONTACT US TODAY

Enhance your services with WAY Trustees. Speak to a member of our team:

Email: info@waytrustees.co.uk
Call: 01202 890 895
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