livingtogether &

Inheritance Tax

Matthew was devastated when Alina died

“We knew it was going to happen, she had been diagnosed with cancer the year before. She was a very practical woman and she made sure her will was up-to-date, and re-filed all her papers so that I would be able to find everything.

We tried to prepare ourselves for what would happen. She told me what she wanted me to do after she had died. She even wrote out what songs she wanted at her funeral. It may sound a bit cold but it wasn't, it was just her way of coping and of trying to help me cope.

When I started trying to sort out her affairs, I was shocked. Before I can even start, I have to pay a huge Inheritance Tax bill. I don't know how I can find the money. I don't want to have to sell our home. We've been here for 16 years and we spent so long decorating and making it ours. It's where all my best memories are, and it's our children's home.”

Contents

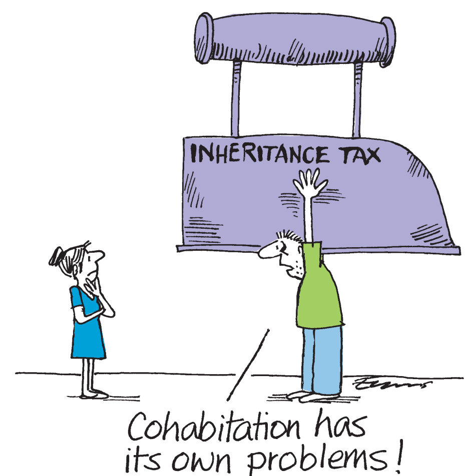
Is it something I need to worry about? 2
How does Inheritance Tax work? 2
Basic planning 4
The problem of the family home 5
Are trusts the answer? 6
How to find an adviser 6
Jargon buster 7
Further information 7

Introduction

Inheritance tax is no longer just a problem for the filthy-rich: after ten years of rising house prices, more and more ordinary people are finding themselves landed with a bill.

It is particularly a problem for cohabiting couples, especially if they own their own home. Unlike married couples or civil partners, couples that live together potentially have to pay tax on anything that they inherit from each other. This means they are also more likely to pay tax on anything they leave to other people, such as their children or family members.

In this leaflet, we'll show you how Inheritance Tax works, how it is charged, and what action you can take to avoid leaving your partner with a whacking great Inheritance Tax bill to remember you by.



Cohabitation has its own problems!

Is it something I need to worry about?

It may be. Inheritance Tax is charged on any estate worth over £300,000 (for 2007–8). This is the 'nil rate band' and it usually goes up every April – it will rise to £312,000 in April 2008, £325,000 in April 2009, and £350,000 in April 2010. Add up everything you own, including your share of the things you own jointly with your partner, and subtract everything you owe; if it comes to over £300,000 you do need to be thinking about it.

How bad is it?

It's fair to say it can be a pretty painful bill to land on your doormat. Anything over the nil rate band gets taxed at a rate of 40%. This can take a significant bite out of the amount you leave, which is not *so* bad if you're leaving your money to a grown-up child or friend; but if it's your partner, it can have drastic effects. It can sometimes mean they have to sell the home you've made together.

The good news is that, with a little tax planning, you can reduce the amount or even avoid a bill altogether.

How does Inheritance Tax work?

Inheritance Tax taxes the things of value you leave behind when you die. You can also be charged Inheritance Tax on gifts you make during your lifetime, especially in the last seven years of your life.

When you die the value of the things you own are added up. Any large gifts you have made in the last seven years are added to the sum. Any debts are deducted. Inheritance tax then has to be paid on any amount over the nil rate band (£300,000 for 2007–8).

Inheritance Tax has to be paid before your money and belongings can be distributed to the people in your will.

Remember, you must make a will. Without one, your partner will not automatically inherit anything from you. See our Wills leaflet for more details.

"YOU MAY HAVE TO SELL YOUR HOME"

Bill and Sarah

Bill and Sarah lived together for 14 years. The house was in Bill's name but he'd left it to Sarah in his will. When he died in November 2005, the house was valued at £310,000.

Two years before he died his sister had hit money problems and he'd given her a lump sum to sort out all her debts. This had to be taken into account in Bill's estate and, along with a bit of savings and his car, brought the total up to £323,000.

The first £275,000 (the nil-rate band for 2005–6) was not taxed. But the remaining £48,000 was taxed at the rate of 40%. Sarah was left with an Inheritance Tax bill of £19,200.

Exemptions

There are, however, a number of ways that you can give money to friends or family members, either in your lifetime or when you die, without having to pay Inheritance Tax on it.

Things you give away more than seven years before you die

Most gifts you make while you are alive are treated as being exempt from Inheritance Tax (what accountants call 'potentially exempt transfers' or PETs). But, if you die within seven years of making any gifts, they will be included in the value of your estate when working out how much Inheritance Tax must be paid. If you don't die within seven years, you are home free.

If you do die within seven years, the people you gave those gifts to might also have to pay Inheritance Tax on them. But they will have less tax to pay if you died between three and seven years after giving the gift, than if you died sooner after giving the gift.

Other exemptions

There are also ways you can give money and property away without being subject to Inheritance Tax, even if you die tomorrow. The main ones are:

- **Anything you give to your husband, wife, or civil partner**. This is where unmarried couples really lose out and why Inheritance Tax planning is particularly important. Some couples even consider getting married for this reason.
- **The first £3,000 of gifts you make each year**. If you didn't use this allowance last year, you can use it this year too. It can't be carried over for more than one year.
- **Small gifts of £250 or less**. These are always exempt as long as the total you've given to any one person in any year is £250 or less.
- **Gifts to family and friends when they get married or enter a civil partnership** – £5,000 is exempt if it is your child getting married/civil partnered, £2,500 if it is your grandchild, and £1,000 for anybody else.

ALL GIFTS MAY BE LIABLE TO INHERITANCE TAX...

- **All gifts to UK charities**.
- **The gifts you make out of your income on a regular basis**. For example, if you pay your ex maintenance or child support, or if you give your brother £100 every month, that won't be counted.

The spouse and charity exemptions are also available when you die. This means you don't have to give your money away now, you could do it in your will.

Even if no exemptions apply, most gifts you make before you die are tax-free because they are either PETs or fall within the nil-rate band for a seven-year period. For most of us, to give away more than £300,000 in any seven years would mean making some very generous gifts!

Reliefs

There are also 'reliefs' which reduce the amount of tax you have to pay on certain things:

- **Business Property Relief** (BPR) – if you own property, machinery or other assets used for a business, the value of them can be reduced by 50 or 100% when working out Inheritance Tax. This includes a 100% reduction in the value of gifts of unincorporated businesses and unquoted shares (which includes AIM shares), though there are some restrictions on qualifying business.
- **Agricultural Property Relief** (APR) – If you own farmland that has vacant possession (or can obtain it within 24 months) the value of the land can be discounted for Inheritance Tax purposes. The value of other let agricultural land and property can be reduced by 50%.
- **Forestry land** can also qualify for BPR or APR.

John's Story

"I've been living with Gillian since the early 70s and we have three children together. We never got married, partly because we didn't want the state to be involved in our personal life, and we've always been very happy with the situation. But now we have hit a problem.

Our home in north London is worth quite a lot of money. If one of us died, the other would have to pay a huge Inheritance Tax bill and might have to sell our home. We've looked into all the different ways of tax planning but, because of our particular circumstances, nothing will work for us. Our solicitor has advised us that there is only one way of avoiding an Inheritance Tax bill – getting married!

We never wanted the state to interfere in our personal affairs and I feel unhappy that it is now. However, I'm a pragmatist. I could stay firm and not get married but that would hardly keep us warm when the tax bill lands on the doormat."

Basic planning

For many people, a little Inheritance Tax planning now will substantially reduce the bill your loved ones will get when you die. Others may be able to avoid one altogether.

STEP 1

The first thing is to work out realistically how much your estate might add up to. You need to look at ways you can get rid of any amount over the nil rate band (£300,000 for 2007–8) but, ideally still giving your money to the people you want it to go to.

STEP 2

Think about where you want your assets to go – and make sure your will is up to date.

STEP 3

You need to get as many assets outside your estate as possible. Make sure that any death benefits – perhaps those due under an employer's pension or insurance scheme – are not included in the estate. You can do this by nominating who it should be paid to.

STEP 4

Where possible, your best bet is to make use of the potentially exempt transfer rules. You could consider equalising your estate with your partner's, or giving your heirs some of the money now. Remember that if you die within seven years they will be counted as part of your estate for Inheritance Tax purposes.

The annual exemption, marriage exemption and expenditure out of income exemption can also add up to useful sums.

STEP 5

Ensure you make full use of the nil rate band that everyone has available (£300,000 for 2007–8).

George and Harriet

When he dies, George's assets add up to £325,000. He leaves it all to his partner Harriet, who has to pay £10,000 in Inheritance Tax. Harriet has assets of her own of £100,000, so when she dies their children get an Inheritance Tax bill of £46,000.

If George had left say £200,000 of his estate to his children and the rest to Harriet, there would still be £10,000 IHT on George's death, but none on Harriet's death, as her nil rate band would cover her estate. This would have saved the family £46,000 because the assets wouldn't have been "double charged". Of course this would only be possible if George knew that Harriet would not need the assets during her lifetime.

Of course, practicalities must be the first consideration – there may be no one else that George wants to give money to, and Harriet may need all of George's funds. In which case, it would have been a good idea to even up their estates before George died by giving Harriet some of his money. Be careful – you can be liable for Capital Gains Tax or Pre-Owned Assets Tax on gifts between unmarried couples, unless it's a cash gift. Get advice.

STEP 6

Consider paying regularly into a life insurance policy that is written to pay out on death to your partner (not your estate), so that they will have enough to pay any Inheritance Tax bill that does occur. The premiums (which count as gifts) will be exempt from Inheritance Tax if they fall within your regular gifts out of income exemption or £3,000 annual exemption.

STEP 7

You could consider investing in business or agricultural property as well. However this can be risky. You should take expert advice.

Double charging and double standards

Married couples and civil partners are not double charged in this way, only unmarried couples. To make things more unfair, changes made to Inheritance Tax rules in October 2007 mean that many married couples and civil partners can now automatically avoid any tax charge at all when their estates are passed on to their children. Now, rather than each partner having an allowance of £300,000 each, married couples and civil partners have an allowance of £600,000 between them.

It's not too late

If you don't manage to do any Inheritance Tax planning before your partner dies, all is not necessarily lost. You might still be able to reduce the overall Inheritance Tax bill by giving up part or all of whatever you are entitled to in favour of someone else. To do this, you'd need to enter into a 'deed of variation' (or, possibly, make a 'disclaimer') within two years of the death. You should speak to a specialist about this.

George and Harriet

By signing a 'deed of variation' on George's death, Harriet could have arranged for £200,000 of his estate to pass directly to their children in spite of what it said in George's will. This would have avoided the 'double charge'.

The problem of the family home

For most people, their main asset is their home. After ten years of rising property prices, even a modest house or flat in expensive areas like London or the South East can push you over the Inheritance Tax nil rate band.

Giving your home away during your lifetime, to your children for example, is unlikely to be a cracking idea. Having security should always be your biggest concern. And although you probably trust the person you would give it to, something could happen that was beyond their control – leaving you homeless.

In any case, if you give the house away but keep the right to continue living there, it will still count as yours when they tot up the Inheritance Tax bill unless you pay rent to the owner at the commercial rate (or if the new owner lives there with you, you pay at least your share of the home-related expenses). This is because it will otherwise be counted as a "gift with reservation of benefit".

Do you own your home in one person's name?

If you do, then, depending on what else you each own, you might want to think about putting it into both names. You must get legal and financial advice about this however, as you would essentially be giving half of your house to your partner, which would be a real problem if you split up.

If you do pass half your home to your partner, he/she would not normally have to pay any Capital Gains Tax because it is his/her "principal private residence".

If you do this, you will need to take steps to avoid the "gift with reservation of benefit" rules. In practice, you can do this by continuing to pay your full share of the running costs of the home, and the cost of maintenance and improvements – and keep records to prove to HMRC that you did.

Do you own your home jointly?

There are two ways to own property jointly, and which you choose makes a big difference when one of you dies.

- **Joint ownership** – when one owner dies the whole property automatically passes to the other joint owner.
- **Tenants in common** – each joint owner has their own separate share of the property which can be left to whoever they like.

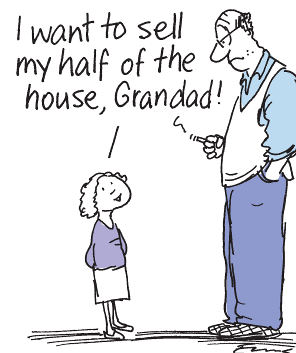
Leaving half the home to someone else

Most couples tend to own their homes as joint tenants. Changing to tenants in common is sometimes a good idea as it opens up the possibility of leaving half the house to the children. However, it is important to stress that this can be a really bad plan – it could result in the family home being half-owned by your partner, and half-owned by children who have moved away. This can, and does, sometimes cause serious problems, both legal and emotional, as they can fall out or the children can try to force a sale. It is also important to remember that, if it is not the children's main residence, the increase in the value of their half since your death will be subject to Capital Gains Tax anyway.

To give or not to give?

Iris gave her holiday cottage in Devon to her children in January 2004. As it was her second home, not her main residence she had to pay Capital Gains Tax, even though no cash changed hands.

Sadly Iris died in December 2005. The value of the property (as a "failed potentially exempt transfer") became taxable for Inheritance Tax purposes, so it ended up being taxed twice. Had she kept the property until she died, there would only have been Inheritance Tax. There is no Capital Gains Tax on what you leave in your estate when you die.



Some people consider reducing the value of their property through various means.

If you have a mortgage, the amount you still owe will be set against the value of the home. So, for some people, taking out a lifetime mortgage is worth looking into, as it reduces the value of the property and generates funds that can be used during your lifetime. Normally you don't pay any interest until you no longer need the home (i.e. when you die or move permanently into care), when you pay it all in a lump sum, along with the amount borrowed.

Another possible route is selling part or all of your home to a specialist company or insurer (this is called "home reversion"). On your death the home is sold, the reversion company gets its share and the rest goes to your estate. The downside here is that you don't benefit from any rise in value of the part you sold.

However, there are big drawbacks with these schemes (often called 'equity release schemes'): the cost can be so high that it wipes out any tax savings, and they are only for people aged 60/65 and older. Do not consider doing this without expert advice.

Giving your home away

There are planning schemes that try to get around the 'gift with reservation of benefit' rules, and enable the owners to seemingly give the property away and yet keep living there. These schemes are usually now hit by the "pre-owned assets" charge, which means you have to pay income tax in some circumstances. If you are contemplating something like this, you must get advice from a properly qualified tax adviser.

Are trusts the answer?

Trusts are sometimes seen as the solution to all tax problems – but, if that ever was the case, it is certainly not true now.

The point of trusts is that they enable you to delay giving money or assets to the eventual owner, and allow you to have some control over how a gift is used. There are two main forms of trust, which are:

- **Life interest or interest in possession** – this gives someone (or a group of people) the use of the trust asset or income for life or for a defined period.
- **Discretionary trust** –this gives the trustees the choice as to who gets the income and capital, and when.

The most common reason for trusts is because the intended recipients are still children. In this way parents or grandparents can put money into a trust (or leave it in a will to a trust) for them. That trust can dictate that the income can be used for the children's upkeep and otherwise saved and paid out, together with the capital, when the children reach a certain age.

Trusts and tax can get quite complicated, and you should get advice on all the implications as both types of trust can be hit by Inheritance Tax, Income Tax, and Capital Gains Tax. Speak to a specialist.

Do you own assets abroad?

Many other countries have some form of death duties, so if you have assets in more than one country you need to look into the possible impact of all sets of tax rules. Many countries also have rules about who can or must inherit from you. Get advice.

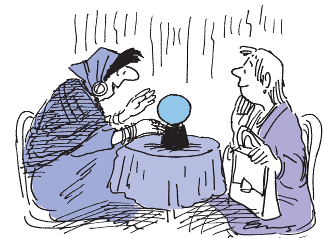
Is your main home outside the UK?

Or are you planning on retiring to the sun?

You may still face a UK inheritance tax bill on all of your assets (whether those assets are based in the UK or abroad) if this is your home country or you have lived in the UK for 17 out of the last 20 tax years. The rules are complicated so, if you are in this position, you should seek advice.

How to find an adviser

You can get advice on Inheritance Tax planning from a **tax adviser** or an **accountant** who specialises in tax. However, you do need to be careful when choosing as anyone can set themselves up as a tax adviser or accountant, even if they have no qualifications or experience. Make sure you choose someone who belongs to a professional institute which requires them to have been trained and taken exams; have professional indemnity insurance; and have a complaints procedure. The two institutes on the right can tell you if an accountant or tax adviser is one of their members, but they cannot recommend one adviser over another.



- The **Chartered Institute of Taxation** can provide you with a list of tax advisers in your local area. Call **020 7235 9381** or search for their members online at **www.tax.org.uk**
- **Institute of Chartered Accountants in England and Wales**. Search for their members online at **www.icaew.co.uk** or call **020 7920 8100**.

Jargon buster

The jargon	What it means
Assets	Things of value (house, savings, shares, car, antique gold necklaces, etc.)
Capital Gains Tax	A type of tax that you have to pay when you sell or give away an asset that has increased in value while you have owned it. See 'Further Information'.
Domicile	The country where the law treats you as having your real home. See page 6 for more information.
Estate	All the assets that you own when you die, minus all the debts you owe.
Exemptions	The ways you can give money to particular people without having to pay Inheritance Tax on it.
Gift with reservation of benefit	Something that you give away, but continue to have the right to use yourself. Anything deemed a 'gift with reservation of benefit' will still be seen as part of your estate when you die.
Nil rate band	This is the amount below which no Inheritance Tax is charged. In tax year 2007–8 it is £300,000. It will rise to £312,000 in April 2008, £325,000 in April 2009, and £350,000 in April 2010.
Probate	The legal ability of the executors of your will to distribute your estate.
Reliefs	Rules which reduce the amount of tax you have to pay. The full value of certain assets is not counted.
Taper relief	A rule that reduces the amount of Inheritance Tax the recipient has to pay on a gift you made to them between three and seven years before your death.
Transfers of value	Things of value that you give to somebody else; gifts.
Trusts	Property held by one person, or a group, for the benefit of another. For more about trusts see page 6.

Further information

For more information about Inheritance Tax:

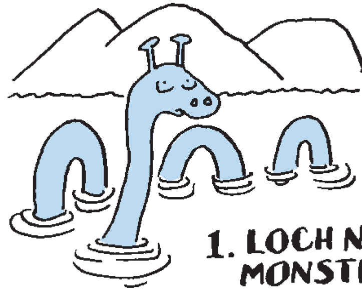
www.hmrc.gov.uk/leaflets/iht.htm

Which? Essential Guide – 'Giving and inheriting'
by Jonquil Lowe.
You can buy it online at www.which.co.uk

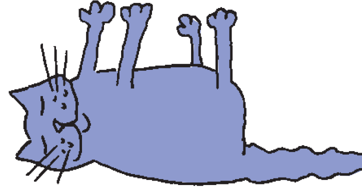
For more information about Capital Gains Tax:

www.hmrc.gov.uk/leaflets/cgtfs1.htm

THREE THINGS THAT DON'T EXIST.



1. LOCH NESS MONSTER



2. CATS' NINE LIVES

This leaflet is one of a series produced by advicenow.org.uk's LivingTogether campaign.

The LivingTogether campaign aims to increase awareness and understanding of the legal issues around living together. We explain exactly what rights couples living together *really* have, and show you practical ways you can protect yourself and your partner.

We provide information and practical material to help you ensure your partner will inherit from you if you die; understand your housing rights and show you how to protect them with a Living Together agreement, explaining financial implications and what you can do to minimise them, and how to ensure your partner is treated as your next of kin in an emergency.

For more information about your rights when you are living with your partner see www.advicenow.org.uk/livingtogether

advice services alliance

ONE PLUS ONE

The LivingTogether campaign is led by Advice Services Alliance in partnership with One Plus One (www.oneplusone.org.uk) and is funded by the Department for Constitutional Affairs.

Advice Services Alliance (ASA), the co-ordinating body for UK advice services. ASA members include Advice[UK], Age Concern England, Citizens Advice, DIAL UK, Law Centres Federation, Shelter and Youth Access. ASA works with its membership and government to develop policy on delivery of legal and advice services; champions the development of high quality information, advice and legal services; and provides supporting services to advice networks.

The LivingTogether Campaign applies to England and Wales only.
The law in Scotland and Northern Ireland is significantly different.

Written by Mary Webber. With thanks to John Whiting, Tax Partner at PricewaterhouseCoopers, and Jonquil Lowe for their assistance. December 2007.

Published by Advice Services Alliance,
CAN Mezzanine, 32–36 Loman Street, London SE1 0EH

The Advice Services Alliance is a company limited by guarantee, registered in England and Wales No: 3533317, registered office 12th floor, New London Bridge House, 25 London Bridge Street, London SE1 9ST

advicenow.org.uk/livingtogether