

Inheritance tax planner of the year

BACKGROUND

Tim (63) and Caroline (59) Jones live in Bournemouth. Caroline is retired and receives a small company pension of £7,500 pa. Tim is employed as a project manager for a telecoms company earning a gross salary of £75,000 pa. His employer provides a non-contributory final salary pension scheme including death in service of four times' basic salary. Tim has a family history of heart problems. He plans to retire within two years, after 30 years' service. Although he has reasonable pension provision, they are likely to require additional income of around £10,000 pa to fund their lifestyle aspirations in retirement. They will receive full State pension.

Tim and Caroline have a daughter Amelia (19). Tim also has a son Joe (28) from his first marriage. Tragically Tim's first wife Jane was killed and Joe suffered a major spinal injury in a skiing accident in 1989. Joe is confined to a wheelchair and needs continuing care. Tim and Jane had arranged joint life first death mortgage protection cover and Jane's will left her estate of £250,000 to Tim, which has helped him support Joe. These funds have been somewhat depleted and Tim holds the balance of £187,500 in a range of OEIC funds, mainly international equities plus some exposure to UK smaller companies. Tim is an experienced investor and happy to accept some stock market risk, where appropriate. Caroline is also comfortable with the downside risks of stock markets.

The Jones's monthly expenditure is £3,000 leaving them currently with surplus net income of £1,500 per month. Both have written wills leaving their estates to the survivor.

Their other assets comprise:

- House owned as tenants in common valued at £650,000, mortgage free.
- House contents valued at £160,000.
- Tim has ISAs totalling £220,000 (£120,000 stocks & shares, £100,000 cash) while Caroline has cash ISAs valued at £50,000.
- Tim has a share portfolio valued at £70,000.
- Caroline has a shareholding valued at £6,000 from a SAYE scheme, transferred on maturity into an ISA.
- Joint savings account containing £65,000 (1.75% gross interest pa).

PROBLEM

Tim and Caroline are worried about leaving their children with a sizeable IHT bill. They wish to quantify their potential IHT liability and solutions to reduce or ideally eliminate this. As well as requiring additional income in the region of £10,000 pa, they also require access to capital for holidays and unexpected events. They are also concerned about securing Joe's financial position following their deaths, as he will require continuing healthcare.

ADVICE

You are required to advise Tim and Caroline about their current IHT liability and to recommend the steps that they should take to mitigate this as far as possible. Your recommendations should include how to meet their requirements for additional income and access to capital.

You should also make recommendations on securing Joe's financial future following the deaths of Tim and Caroline. In addition you should outline in bullet point format any other areas and risks that should be brought to their attention.

alan seward | **financial services**

Inheritance Tax Planning Report

By Matthew Rich

Objectives and Priorities

1. To reduce and ideally eliminate your children's Inheritance Tax (IHT) bill.
2. For Tim to retire in 2 years with an income of £10,000 net per annum from your investments in addition to your pensions.
3. To have access to your capital.
4. To secure Joe's financial future.

Assumptions

1. I am assuming a medium risk portfolio with 50% in global equities, 30% in global fixed interest and 20% in commercial property with an annual return of 5.5% net of tax and charges.
2. You are UK resident, ordinarily resident and domiciled for tax purposes.
3. Tax rates are for 2011/12.
4. Current legislation remains the same.
5. You have made no previous gifts or Potentially Exempt Transfers (PETs) or set up any trusts in the last 7 years.
6. You are married.
7. Tim's final salary scheme has a 60th accrual rate.

Attitude to risk

I recommend we undertake a full risk profiling for you both but for now you have said you are happy to accept some stock market risk so I will define you as medium risk. I have discounted unquoted share based IHT solutions as being too high risk for you.

Assets

Owner	Asset	Value
Joint as tenants in common	House	£650,000
Joint	House contents	£160,000
Joint	Cash savings	£65,000
Tim	Cash ISAs	£100,000
Tim	Stocks and shares ISAs	£120,000
Tim	Shares	£70,000
Tim	OEICs	£187,500
Tim	Final Salary Pension	30 years
Caroline	Cash ISAs	£50,000
Caroline	Share ISA	£6,000

Income and Expenditure

- Tim has a salary of £75,000 gross per annum and Caroline has a pension of £7,500 gross per annum.

- You currently have surplus income of £1,500 per month.

Current IHT situation

Total assets	£1,408,500
Minus funeral expenses	£6,000
Nil Rate Bands	£650,000
Taxable estate	£752,500
40% IHT	£301,000
1% probate costs	£14,025
Tony's Death in Service	£300,000
Amount available for your children	£1,387,475

My recommendations

Save into a pension

For the next 2 years you have disposable income of £1,500 per month and additionally the Discounted Gift Trust I am recommending will generate a further income of £10,000 p.a.

Given Tim is a higher rate tax payer and making no personal pension contributions I recommend he saves £1,250 per month from your disposable income into a personal pension or buys additional years from his final salary pension. For now I have based the plan on paying into a personal pension.

If you make these contributions using salary sacrifice you will get immediate 40% tax relief on your whole contribution and your and your employer's National Insurance savings can also be added to your pension meaning a total of £30,000 p.a. will be paid into your pension which will be within your annual allowance.

Paying £30,000 p.a. into a pension for 2 years at 5.5% growth rate will produce a total of fund of circa £63,000. If it were required this could be taken as a lump sum with 25% of it tax free or it could produce an inflation proofed income within your pension of circa £2,500 p.a.

I recommend Caroline pays £240 per month into a stakeholder pension as this will obtain 20% tax relief to make the contribution up to £300. Paying £3,600 p.a. into a pension for 2 years will produce a total of fund of circa £7,600 which will produce tax free cash of £1,900 and an annual inflation proofed income of circa £200 p.a.

If you have nominated a beneficiary for your pensions there will be no IHT if you die before drawing benefits and I recommend you set up a spousal bypass trust so there will be no IHT on your spouse's death.

the house but is subject to a charge on it that will be repaid to the trusts usually on their death which will reduce their estate by the amount of the debt.

Careful drafting of the wills, selection of executors and trustees (who must be different people) and evidence of trustee meetings and decisions will be required.

The trustees will need the power to increase the amount of assets that go into the trusts if the NRB increases in future and to decide what assets go into the trusts.

If Tim dies first I suggest the assets that go into the trust will be his share of the house (in the form of a charge on the house), his OEICs and shares and some of his ISA portfolio to equal 2 times the NRB. If Caroline dies first I suggest the assets that go into trust will be her share of the house topped up with cash from her savings account. On second death, the house can be sold so that the charge can be repaid and cash put in the trust.

In the meantime some repositioning of Tim's assets should be considered to ensure they match his risk tolerance. It may well be that not much can be done with his OEICs without triggering a CGT charge and that only his ISAs can be changed. This may mean that all his ISAs are invested in fixed interest assets to balance his OEICs which are in equities.

The beneficiaries of the trusts will be the surviving spouse and your 2 children.

The trust can be given the power to make interest free loans to the surviving spouse. This will allow the spouse to have access to whatever income or capital they require without actually owning the assets. Crucially they will have no absolute right to any income or capital and the trustees could call in any loans and charge placed on the house at any time.

After the surviving spouse dies the children as remaining beneficiaries can wind the trust up and have the assets or pay out money to Amelia but keep the trust going for Joe to protect his state benefits should this be important.

Gifting assets into discretionary trusts on death will allow you to have 3 Nil Rate Bands including Jane's. The remainder of your estates will pass to your spouse under the spousal exemption.

Whole of life insurance in a discretionary trust

I recommend 2 joint life second death whole of life (WOL) insurance policies are set up in discretionary trusts are taken out for £150,000 each on a guaranteed premium basis which will cost circa £320 per month in total.

The monthly payments into the policies will be within your normal regular expenditure exemption and on second death £300,000 will pay out into the

trusts either to be invested or to be paid to the beneficiaries which will be your children.

Discretionary Discounted Gift Trust (DGT)

A gift is made into a discretionary trust. The trust creates 2 separate rights. Your right to a fixed lifetime income and the trustees right to whatever is left in the trust fund when you die. The value of your right to an income is based on the amount of income you draw and the number of expected payments you will receive over your lifetime. The total invested minus the value of the income equals the discounted gift.

The discounted gift is a chargeable transfer but because it is well under your NRB it will not face a tax charge. Investment growth is outside of your estate and the gift is fully exempt if you survive 7 years and receives a reduced tax rate if you die after 3 years. The discounted value is taken into account for IHT planning so there is an immediate tax saving. However there is no scope for altering the income.

I recommend that you invest £200,000 jointly into a Discretionary DGT that invests in an offshore bond in a medium risk portfolio.

I recommend you take 5% income to meet your £10,000 annual income requirement.

The discount will be based on an investment of £100,000 each and be circa £56,000 for Tim and £68,000 for Caroline, so the discounted gift value for IHT purposes will be £76,000. The discounts will have to be verified by a medical examination to act as evidence to HMRC of the validity of the discount.

I recommend you take out 7 year level term insurance in a discretionary trust to cover the IHT bill due on the bond if you were to die in the next 7 years at a total cost of circa £35 per month.

I recommend the trust is funded £180,000 from Tim's ISAs and £20,000 from Caroline's savings account. However the money will need to be moved to a joint account prior to investing in the DGT to ensure the validity of the gift.

Type of trust

I recommend you use discretionary trusts as they give flexibility to advance money to either Joe or Amelia depending on who needs what and when.

Additionally a class of grandchildren could allow the trustees to advance money to grandchildren if any are born in the future.

This trust will not affect Joe's benefits entitlement. This means that it could be in Joe's best interests to keep the trusts running for a long period of time after you have both died rather than end the trusts which would mean having the money in his name which could affect his benefits.

Keeping the trusts going may mean in future the trusts face periodic and exit charges. The potential for a tax charge could be avoided using a disabled person's trust however given the size of the gifts and the fact they are made into unrelated trusts means a periodic charge is unlikely.

I recommend you use an impartial professional trustee for all your trusts who understands your wishes with regards the trusts assets to avoid any arguments about what each beneficiary receives.

Type of underlying investment

I recommend you invest in offshore bonds in a medium risk portfolio.

The bond will pay virtually no tax whilst it is offshore and you can draw 5% of the investment capital per annum for 20 years with no tax liability.

If you need to exceed the 5% amount, the best thing would be to assign segments of the bond to a beneficiary so they can encash money in their own name if they do not pay 50% tax.

Bonds are disregarded by local authorities and benefits agencies for means testing as they are considered to be life insurance policies and non income producing.

I recommend you have both children as lives assured to give them control over when to encash the bond.

Money can be paid directly by the trustees for items or care that is required. Certainly we would not want to pay Joe a regular income or pay him capital which would sit in a bank account as this could cause problems with his benefits.

Result

1. You will receive £10,000 p.a. from the DGT plus income from your pensions.
2. You will also have access to £400,000. This will be in your name while you are both alive and then after first death up to £300,000 of this will be in trust but as a beneficiary the surviving spouse will still be able to access this money by way of a loan from the trust albeit at the trustee's discretion.
3. This planning will mean after you have both died there will be circa £1.5m in trust free of IHT for your children with Joe able to access at least half of this to meet his needs.

Other issues

1. You should each appoint a Lasting Power of Attorney so that a trusted individual will look after your property and financial affairs and your health and welfare in accordance with your wishes should you become incapable of doing so yourselves. Joe should also do this.
2. You should provide a non binding letter of wishes to your pension providers.
3. Establish pilot spousal bypass trusts for Tim's death in service and pension benefits with trustee powers to loan money to beneficiaries.

Order of action required

When	Action	Who
Day 1	WOL policy 1	Planner
Day 2	WOL policy 2	Planner
Day 3	Pilot trusts – one each	Solicitor
Day 4	Tim's Pilot trust	Solicitor
Day 5	Tim's Pilot trust	Solicitor
Day 6	Tim's Pilot trust	Solicitor
Day 7	Tim's Pilot trust	Solicitor
Day 8	Change tenants in common % split and rewrite wills	Solicitor
Day 9	Discounted Gift Trusts	Planner

Review

I recommend we review your plan every 12 months or sooner if legislation changes.