Inheritance tax planning in the Credit Crunch

A key part of making successful financial decisions is to avoid making mistakes. How often are the flaws of previous actions or inactions highlighted by hindsight? This is particularly relevant within the realm of inheritance tax (IHT) planning, where many people believe they face a choice between sacrificing their future financial security and paying more IHT. The current bleak economic climate of falling asset prices and rising inflation will undoubtedly cause more people to defer making any decisions. This article highlights a planning opportunity, which allows you to achieve considerable IHT savings without impacting on your current or future financial security.

What everyone wants – to reduce IHT without losing access to capital/assets

This has always been the ultimate objective for many people. Unfortunately, various governments have enacted legislation to prevent people 'having their cake and eating it'. The 'reservation of benefit' and 'pre-owned asset' rules have severely limited the scope to make IHT effective gifts whilst retaining access to an income or capital. Schemes such as Discounted Gift Trusts (DGTs) and Loan Trusts are some of the few ways to achieve this goal. However, the inflexibility of these schemes can create problems.

A key issue with DGTs is that there is no access to capital and the income level is set in stone at outset. Few people would normally choose an investment with such restrictions. This can be seen by the general antipathy to pension annuities, where a capital sum is swopped for a set income for life. A DGT involves a similar concept, but at least any capital remaining on death is available to the trust beneficiaries. However, a DGT presents long term planning issues. Over fifteen years, an income set at 5% of the initial fund value will fall by 45% in real terms with an inflation rate of 4% per annum. As current market conditions show, with falling asset values and rising inflation this can seriously derail the income of someone over longer periods of time. Why commit to a fixed income and no access to capital when you don't have to? Furthermore, the paradox of a DGT is that although the discounted investment falls outside of your estate after 7 years, monies are returned to your estate every year for life; unless these monies are spent, your IHT liability will simply build up again.

A **Flexible Reversionary Trust** allows you to structure your future income and capital needs to your exact requirements, but more importantly provides the flexibility to change them in the future.

How does it work?

You invest up to a maximum of your nil rate band (£312,000 for 2008/09) into either unit trusts or offshore life assurance bonds and transfer these into a trust for the benefit of chosen beneficiaries. Beneficiaries' entitlements can be changed in the future. You 'carve out' a series of annual payments or 'reversions' which are due to be paid back to you during your lifetime, e.g. 10% of the initial investment plus any growth for 10 years. In the normal course of events, these reversions would be paid to you and the trust depleted after the ten years. The flexibility of this trust comes through the ability of the trustees (selected by you the investor) to defer any reversions to future dates. In this way, you are not committed to receiving a fixed 'income' from outset. Reversions can be deferred indefinitely allowing the trust fund to grow. If all reversions are deferred then after seven years the full trust value will be outside your estate, yet you will retain access to 100% of the trust value through future reversions. Importantly the trust is flexible enough for capital to be paid to any potential beneficiaries at any stage. This level of flexibility is simply not available from other planning solutions.

Why is it important to plan as early as possible?

Inheritance tax is often described as an avoidable tax. However, most people miss out on one of the most useful tax allowances, the lifetime nil rate band. Most people only use their nil rate band once, on death. Outright gifts made at least seven years before death escape any charge to IHT and leave a full nil rate band (£312,000 per person for 2008/09) to utilise on death. Since 2006, most transfers into trust are effectively restricted to the nil rate band or an immediate tax charge of 20% is payable on any excess. As with outright gifts, the full amount transferred will fall outside your estate after seven years. Most importantly, you can go through the whole process again as you receive a further lifetime nil rate band after each seven year period. Before 2006, as

transfers into trusts were effectively unlimited, there was no urgent need to begin planning with the lifetime nil rate band. This situation has reversed since 2006, and it is now imperative to start as early as possible to maximise your lifetime allowances.

So what does the Flexible Reversionary Trust achieve?

- Removes the entire value of the gifted capital from your estate after 7 years. Based upon an initial investment of £312,000 this would save £124,800 of IHT.
- Offers access to 100% of both the capital and any investment growth in the future.
- Has flexibility to add further or change existing beneficiaries' entitlements without any income tax, CGT or IHT implications within the trust.
- Uses accepted planning techniques which HMRC have confirmed are not caught by either the gift with reservation of benefit rules or pre-owned assets tax.
- Can be utilised with either life assurance bonds or unit trusts/OEICs.
- Utilising unit trusts or OEICs ensures growth is only subject to 18% CGT, rather than the maximum 40% income tax which life assurance based schemes can attract.
- Is simple and easy to administer.
- Can be utilised with the gifts from income exemption for those people with an income surplus. There is no seven year waiting period for gifts out of income and you are not limited to the nil rate band of £312,000 every seven years.

Conclusion

The reality of why so many people take out Discounted Gift Trusts is that few people understand the alternatives. When compared to a Loan Trust the DGT seems to offer considerable advantages. However, most people would find a Flexible Reversionary Trust far more suitable. It allows you to plan far earlier than would be recommended with a DGT, and you can maximise your lifetime nil rate band every seven years without worrying that you will lose complete access to your capital.

Many people are put off using trusts because of their perceived complexity and high costs. Even with the cost of advice and any ongoing administration costs the total costs should not prove much higher than the costs associated with an average unit trust investment, if you seek advice from a specialist fee-based planner.

Concerns over investing at this time are not really valid, as you can gain access to the full range of asset classes from cash to equities within the trust, and you can change the underlying investments at a later stage. As you retain potential access to your capital, you need not worry that your future financial security will be at risk.

Don't let the current market conditions prevent you from undertaking sound planning, but make sure you do not fall into the trap of being caught in an inflexible structure, which cannot adapt to your changing circumstances, economic conditions or legislative changes.

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