

CFG Wealth Management

Inheritance Tax Case Study 1

Our prospective clients, married, aged 62 and 60, with 3 children and 2 grandchildren had been able to take early retirement as a result of a substantial sum inherited from his late mother. However they were extremely concerned about Inheritance Tax after it had become clear the amount that the government had deducted from the estate in spite of a Deed of Variation having been done following his father's death several years earlier. From the residual estate of over £1.1 m the net amount passed to him had reduced to £800,000 as a result of Inheritance Tax. Although he and his wife had discussed a further Deed of Variation to allocate part of the estate directly to their children they had decided not to do so and been introduced to us to arrange life assurance cover instead to pay out on second death to cover their own IHT bill.

As with other clients with similar requests we informed them that using a whole life policy was really just a way of funding the inheritance tax in advance and that in the first instance they should be trying to mitigate the tax. They explained that their main concern was that they did not want their children receiving large amounts of capital at this stage. They also felt that they would need the income for themselves so were not keen on the idea of the capital being tied up in a trust. However they would carry on making small gifts but wanted to ensure that if they both died prematurely there would be cash provided to meet the tax. Nevertheless we were able to convince them to allow us to carry out an appraisal of their options and prepare a report.

We asked him to provide a list of their assets, income and expected expenditure to enable us to obtain a full financial picture. We also requested details of any capital transfers in the last 7 years to the family. We calculated that their combined estates were around £2.4 million, including the £800,000 inheritance, a stock market portfolio, their main residence and a holiday property abroad. They confirmed their combined pension income was about £40,000 p.a. after tax while stock market dividends added a further £20,000 p.a. The husband's pension scheme had also paid him a cash lump sum on retirement and after clearing the remainder of their mortgage there was around £50,000 left on deposit. They had also estimated that their outgoings including holidays would continue to be close to £80,000 per year and said that they wished to maintain their new retirement lifestyle for as long as their health remained good.

We asked them how important having access to capital was bearing in mind that they had a large stock market portfolio and that, by their own admission, their home was much larger than they needed and that they would intend downsizing at some future date, and that the holiday home could be sold if necessary. They already had an 'emergency reserve' of £50,000 that could be used if necessary. Although initially they said they wanted to have access to the inherited capital, they were unable to say why that was necessary, and after some discussion accepted the fact that there was nothing they might need a lump sum for, which could not be obtained from elsewhere.

After considering the various options we recommended they split the inheritance between them and then transfer the capital into a joint settlor Discounted Gift Trust. This would give them an immediate reduction on their estates, and provide them with a tax free income. After explaining how the DGT scheme worked they elected to take 5% per annum as income even although that would give them more than they actually needed. The advantage was that the higher income of £40,000 per annum would enable a larger reduction in the value of their taxable estate, and that the excess income would enable them to gift £3,000 p.a. each to the family as well as gifting excess pension income using the 'gifts from normal expenditure' exemption. Of the £40,000 after tax pension income, £14,000 would qualify under the 'normal expenditure' exemption and together with the annual gift exemption their estate would reduce by a further £20,000 per year.

We also discussed who they wished to benefit from the trust capital on their eventual death. They felt that they wanted to include their grandchildren but thought there might be some additions to the family so wanted flexibility to amend the beneficiaries in future. We therefore recommended the DGT scheme be established under discretionary trust.

We explained that if they placed £800,000 into a DGT then assuming they were in normal health the value of the gifted capital would be reduced for IHT purposes by 44% and that as £448,000 was within their combined 'nil rate' band (after taking into account chargeable transfers made in the previous 7 years) this meant that no immediate charge to IHT would arise and, furthermore, there was very little likelihood of any periodic or exit charges either.

Although there was still the possibility of a tax charge on their estates in the event of the premature death within the next 7 years, this was to be covered by short term assurance policies at much lower premiums than would have been needed for the whole of life policy they thought they wanted! Assuming both spouses live long enough as estimated the total IHT saving from the proposed arrangements would equate to around £480,000 with virtually no risk to their own financial security!

Karen Reid
Associate Director
CFG Wealth Management
0141 249 6890
karen@cfgwealthmanagement.co.uk