Inheritance tax: how to cut your bill

We reveal four ways to pay less tax – and help one couple cut the bill they could leave from £186,000 to less than £75,000

PHOTOGRAPHY MIKE CHARITY

Inheritance tax has hit the headlines repeatedly this year – most recently when Princess Margaret's children sold off the family silver to cover an estimated £3m tax bill on her estate.

The bad news is that you don't have to be a Royal – or even rich – to attract the attention of the tax authorities. The good news is that there are simple, practical steps that you can take now to reduce the size of the bill they will send your inheritors.

The problem has been triggered by the rapid rise in house prices – and the fact that the threshold at which the tax becomes due has not been increased quickly enough to keep pace with this boom. The tax-free threshold is £285,000 for deaths in the 2006-07 tax year – around the UK average price for a detached house. If your estate (plus any gifts you have made in the previous seven years) is worth more than this, your inheritors will have to give 40 per cent of everything over the limit to the tax authorities, apart from some tax-free gifts. The threshold does go up each year but will be only £325,000 by 2009-2010.

The Chancellor has stopped some of the more sophisticated schemes designed to avoid the tax – see 'Loopholes closed', right. But straightforward ways to save money remain open. We asked two tax experts to help two *Which?* readers (see right) reduce the tax bill they will leave behind – and offer advice to everyone planning for the future.

Many of those affected by inheritance tax are far from rich

1 MAKE GIFTS TO YOUR CHILDREN

What they could do Our experts pointed out that David and Margaret can each give gifts up to £3,000 in a tax year, tax-free (£6,000 if they have made no gifts in the previous year). This would reduce the size of their estate on death.

What you can do Making tax-free gifts is probably the simplest way to reduce your tax bill if you have savings that are accessible and surplus to your needs. Some other gifts are tax-free, such as gifts from your income that form a regular pattern and do not reduce your standard of living – see the *Which? Tax Saving Guide 2006-2007*. Gifts of over £3,000 a year also become tax-free if you survive for seven years after making them, except for most gifts to trusts (see 'Loopholes closed', right).

TAX SAVED £2,400 a year as a couple

Watch out Don't make gifts in name only – such as giving your home to your children but continuing to live there. This is known as a 'gift with reservation' and will still form part of your estate when you die. Even if the gift escapes this net, it may be caught by new rules on 'pre-owned assets' that charge income tax on any benefit you get from something you used to own (see 'Loopholes closed').

2 USE BOTH TAX-FREE THRESHOLDS

What they could do Under the Johnstons' wills, when the first partner dies everything will go to their spouse. This will be tax-free because they are married. But on the second death, the whole lot is taxable, with only one person's tax-free threshold to deduct. This wastes the other partner's tax-free threshold and could mean an extra tax bill of £114,000 in today's terms. David and Margaret can avoid this by leaving a lump sum below the tax-free threshold in their wills to children or grandchildren on the first death. They haven't got enough free cash to do this now but they may move to a smaller house; if so some cash could go to the children either immediately or in their wills.

What you can do If you already have significant savings or are planning to downsize, consider giving some of this to your children/grandchildren rather than leaving it all to your partner.

TAX SAVED £40,000 for each £100,000 given to someone other than your spouse

Watch out Giving too much cash to your children risks leaving a widowed partner short of cash. Giving cash directly rather than through a trust (see right), also means you lose any control of the money.

3 SET UP A TRUST

What they could do Instead of leaving cash, the Johnstons could rewrite their wills so that each leaves their share of the house – up to the tax-free threshold – to a discretionary trust. A trust is a legal arrangement where trustees – who could be family members – hold money or possessions for the benefit of other people (the beneficiaries). On the first death, the trustees would inherit this share but sell it to the surviving partner in return for a promise of payment on the survivor's death. On the second death, the trust is paid back from the estate, reducing inheritance tax. This scheme is not affected by the new trust rules – see 'Loopholes closed'.

What you can do Leaving your house to a trust is worth considering for everyone in the inheritance tax bracket. You can also put investments – say, to pay for a child's education – into a trust, but the running costs of this type of trust mean that it is only worthwhile if you put in at least £100,000.

TAX SAVED £114,000 if the whole of one tax-free threshold is used

Watch out You will need legal advice to set up a trust (see 'Checklist') and must own your home as 'tenants in common' (a solicitor can arrange this).

WE HELP TWO READERS DEFUSE A £186,000 INHERITANCE TAX BOMB

David and Margaret Johnston

67 and 62, retired teachers

The rise in the value of the Johnstons' house – now worth £650,000 – has pushed them into the inheritance tax bracket. They also have around £100,000 in savings and investments. There will be no tax due when one of them dies, because they are leaving everything to each other and gifts between wives and husbands are tax-free.

However, on the second death, their two children will have to pay tax at 40 per cent on everything above the tax threshold – currently £285,000. That means they could be facing a £186,000 bill.

The Johnstons would like to pass on as much as possible to their children. Income isn't a problem at present – they still do some part-time work. But they can't afford to give away too much now.

Our experts came up with four ways to defuse the tax bomb (see below), saving their heirs a minimum of £114,000 if they were to inherit now.

The Johnstons would like to pass on as much as possible to their children

Number of people on whose death inheritance tax is potentially payable	2002	2009
	2.1m	3.3m

SOURCE: GRANT THORNTON/LOMBARD STREET RESEARCH

4 INSURE TO COVER THE TAX BILL

What they could do Rather than give away any assets before they die, the Johnstons could take out a life insurance policy to pay some or all of the tax bill they leave behind. For example, a 'whole life' policy which pays out £100,000 on the second death would cost them around £180 a month. If the policy is 'written in trust' for the Johnstons' family, the proceeds on death will go straight to them without counting as part of the estate. There will be no tax to pay provided the policy value, plus other taxable gifts, comes to less than £285,000.

What you can do If you buy a life insurance policy, ask your insurer about 'writing it in trust'. If you do not, the proceeds will go into your estate when you die and may increase any tax bill. Taking out a policy avoids your heirs having to sell assets to pay the tax, but it may be costly if you are in poor health.

TAX SAVED None – but the policy payout should help towards the tax bill

Watch out Life insurance trusts are affected by the new rules (see 'Loopholes closed'), but only if the policy value, plus other taxable gifts, is more than £285,000. Policies written in trust before 22 March 2006 are unaffected unless beneficiaries are added.

Loopholes closed

The latest law changes explained

The Chancellor has taken steps in recent years to tackle inheritance tax avoidance.

In 2005 the target was schemes to get round the rules of 'gifts with reservation'. These treat something you give away but continue to benefit from as part of your taxable estate on your death. Now, even if your gift is not caught by the rules, it may be caught by new 'pre-owned asset' rules which charge income tax in your lifetime on any benefit.

The 2006 budget made most trusts liable to inheritance tax – previously gifts to some trusts were tax-free if you lived for seven years after making them. If a trust is caught by the new rules, money going into it is taxable at 20 per cent if it takes the giver over the £285,000 tax-free threshold. The trust may also have to pay tax every ten years if the money in it exceeds the tax-free threshold, but at a maximum rate of six per cent.

Checklist

What you should do now

- **Be sensible** Don't put the financial security of you or your partner at risk to save tax – you won't be the ones to benefit.
- **Give what you can** Pass on money and possessions in your lifetime if you can do so without jeopardising your own security.
- **Make a will** If you've already got one, review it.
- **Trusts** If your will sets up a trust on your death, ask your solicitor whether it is affected by the changes to trusts.
- **No change** Beware of changing an existing insurance policy written in trust – ask the insurer if the change will bring it within the new trust rules.
- **Variation** Within two years of a death, the beneficiaries can agree to change who inherits what, using a 'deed of variation'. This may save inheritance tax. If someone dies leaving everything to their spouse and the survivor decides they won't need it all, the will can be 'varied' so that part goes to someone else.
- **Get advice** Get professional advice before making any major decisions. Solicitors and tax advisers should be able to help: specialists may belong to the Society of Trust and Estate Practitioners – www.step.org or 020 7838 4885.

Correction

TAX SAVING GUIDE 2006-2007

Inheritance tax, p53

In the 'IHT-exempt gifts at a glance' box, p54, under 'Gifts made during lifetime or on death', the £55,000 limit on tax-free gifts between spouses and between civil partners applies only when the party who is making the transfer is domiciled in the UK and the recipient is domiciled abroad.