YOUR GUIDE TO

Inheritance Tax

PUMA
INVESTMENTS

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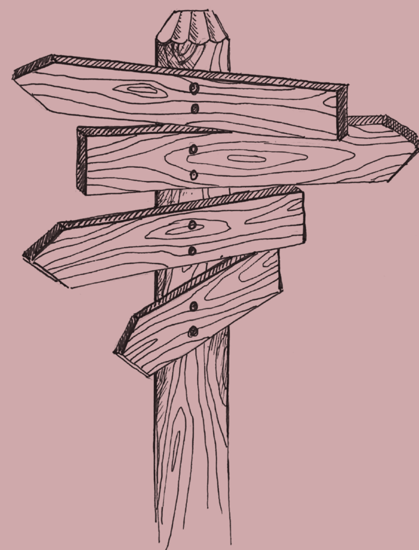


Inheritance tax has been described as the "most hated tax of all".[1]

People dislike the idea that money they've already paid tax on, is taxed again when they die. The good news is there are steps you can take to mitigate the impact of inheritance tax.

In many cases, and with the right planning, you may not have to pay inheritance tax at all.

[1] This is Money article: Inheritance tax is named Britain's most hated levy, October 2021

What is inheritance tax?

Inheritance tax is payable on the value of your estate when you die. Your estate is broadly everything you own.

Your estate includes property, savings, investments and life assurance.

Once the value of your estate has been calculated, there are allowances before inheritance tax is payable. The current rate of inheritance tax is 40%.

Any outstanding credit card balances, loans and mortgages can be deducted from the value of your estate before any liability for inheritance tax is calculated. Funeral costs and charitable donations count too in reducing the value of your estate.

Summary of allowances

NIL-RATE BAND

There is a nil-rate band of £325,000 per person. If the value of your estate is less than this, nothing is usually payable.

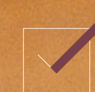
RESIDENCE NIL-RATE BAND

The residence nil-rate band is £175,000. It applies when a property is passed to a “direct descendant” (for example children, grandchildren, or step-children, but not nephews, nieces, cousins, siblings etc). This allowance doesn’t apply to second homes or buy-to-let properties.

For estates worth over £2 million, the residence nil-rate band is reduced (for every £2 over the £2 million threshold the amount reduces by £1). This means if your estate’s net value is £2,350,000 or more, your residence nil-rate band would be zero.

TRANSFERRING ALLOWANCES

Both the nil-rate band and the residence nil-rate band can be transferred between married couples or civil partners when one partner dies. This means the total value of an estate before any inheritance tax is due could be £1 million for a couple. Transferring allowances applies to people who are married or part of a civil partnership, but does not extend to couples who live together.



FACT

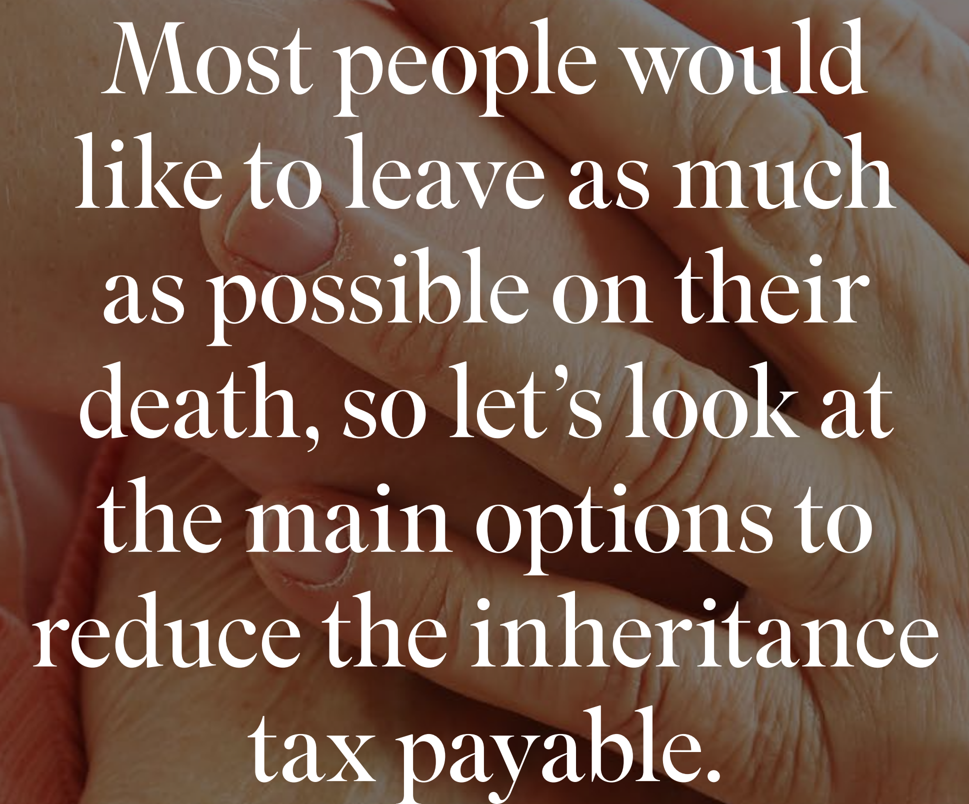
Both the nil-rate band and the residence nil-rate band have been frozen until April 2028

Why inheritance tax planning is important

Between April 2021 and February 2022, Britons paid £5.5 billion in inheritance tax, which is £700 million higher than in the same period a year earlier.[1]

This figure could increase significantly going forward. The thresholds for paying inheritance tax have been frozen until April 2028, and this means that it is likely that more estates will become liable to inheritance tax, thanks to the rises we have seen in house prices and soaring inflation.

[1] Source: gov.co.uk, March 2022



Most people would like to leave as much as possible on their death, so let's look at the main options to reduce the inheritance tax payable.

How to reduce your liability

If the value of your estate exceeds the nil-rate bands, even after transferring these bands between couples, there are other options to reduce your inheritance tax liability.

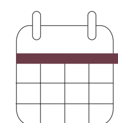
1. GIVE AWAY MONEY EACH YEAR
2. MAKE “GIFTS” DURING YOUR LIFETIME
3. RELEASING EQUITY FROM YOUR HOME
4. TREATMENT OF PENSION SCHEMES ON DEATH
5. USING LIFE ASSURANCE
6. USING TRUSTS

+ INVESTING IN COMPANIES QUALIFYING FOR BUSINESS RELIEF

The detail provided here is intended to provide a high-level informative summary of inheritance tax liability, and therefore should not be read as advice. Please consult an independent financial adviser for personalised advice that takes into account your specific circumstances.

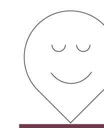
1. Give away money each year

There are a number of ways to do this.



ANNUAL EXEMPTION

You can give away up to £3,000 every year. You can also use any unused allowance from the previous year, so you can give away up to £6,000 if you didn’t make any gifts in the previous year.

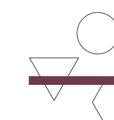


DONATIONS TO CHARITY

Any payments you make to a UK registered charity are exempt from inheritance tax. You can also qualify for a 10% discount on your inheritance tax bill, if you leave 10% or more of your net chargeable estate to charity.

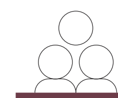
GIFTS TO MUSEUMS, UNIVERSITIES AND POLITICAL DONATIONS

These are exempt from inheritance tax.



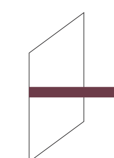
SMALL GIFT EXEMPTION

You can make small gifts of up to £250 to as many people as you like.



GIFTS TO PARTNER, CHILDREN AND GRANDCHILDREN

Gifts to your spouse or civil partner are exempt, as are gifts of up to £5,000 to children when they get married (£2,500 to grandchildren) and £1,000 to anyone else.



GIFTS OUT OF EXCESS INCOME

If you don’t spend all of your regular income, after your outgoings have been paid, you can use any surplus money to provide a regular financial gift.

2. Make "gifts" during your lifetime

You can make a gift that's not liable for inheritance tax, even if it falls outside the exemptions listed, if you survive for seven years after making the gift. There is no limit on the amount you can transfer in this way. The technical name for this is a "potentially exempt transfer".

If you die within seven years of transferring money this way, it will reduce the nil-rate band available on your death. This means inheritance tax could be payable. If the value of money gifted this way is more than the nil-rate band, then so-called "taper relief" is available. This will reduce any inheritance tax liability on the amount over the £325,000 nil-rate band.

YEARS BETWEEN MAKING GIFT AND DEATH	TAPER RELIEF
0-3	No taper relief
3-4	20%
4-5	40%
5-6	60%
6-7	80%
+7	No tax due

Source: gov.co.uk, March 2022

3. Releasing equity from the home

Equity release is a way to use the equity in your home without selling or downsizing. Typically, it's a loan against property, where the money you release can be gifted or spent to reduce the overall value of your estate.

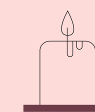
The proceeds of the loan are free of income and capital gains tax. It works like a conventional mortgage, except you don't have to repay anything during your lifetime (though there are schemes that allow you to repay some or all of the interest). On your death, or if you need to move into a care home, the property is sold and the loan plus unpaid interest is repaid.

Equity release can mitigate inheritance tax:

- The value of your estate is reduced by the amount of the loan plus any interest owed when you die.
- The money you release can be gifted during your lifetime. So long as you live for a further seven years, there will be no inheritance tax to pay.

4. Treatment of pension schemes on death

There are two types of pension scheme:



Defined benefit schemes

Sometimes called "final salary" schemes, these schemes pay a guaranteed income each year, usually expressed as a percentage of your earnings. Treatment of any benefits payable on death, depends on whether you die while you're still working for the company, or you've retired.

Death in service

If you die while you're still working for the company, these schemes often pay a lump sum. The lump sum is usually paid under a discretionary trust and does not form part of your estate. There may be a beneficiary's pension payable too, which is taxable as income.

Death after retirement

If you're receiving a pension from a defined benefit scheme, some or all of your pension may continue to your partner or other beneficiary on your death. Again, this is taxable as income.

Defined contribution schemes

Often called "money purchase" schemes, money paid into a defined contribution scheme is invested in funds you can access from age 55. You can take up to 25% as a tax-free lump sum and the rest can remain invested (called "drawdown") or used to buy a guaranteed income for life (called an annuity). The treatment of benefits payable on death depends on whether you die before age 75 or after.

Death before 75

If you die before age 75, your drawdown fund or any death benefits from an annuity are completely free of any inheritance tax.

Death after 75

If you die after age 75, any fund remaining or any death benefits from an annuity are taxed as income at the marginal rate of the person receiving the benefit.

5. Using life assurance

Life assurance doesn't reduce how much inheritance tax you have to pay, but it can be used to preserve the assets you plan to leave. It can also cover any inheritance tax liability, if you've made a potentially exempt transfer and die within seven years. Life assurance may pay a lump sum into a trust, which remains outside your estate and can be used to settle your inheritance tax bill.

The two main options are:

Whole of life assurance

As the name suggests, this type of policy will pay a lump sum to your beneficiaries when you die. This can be used to pay inheritance tax on your estate. Whole of life assurance tends to have higher premiums (than term assurance) that on certain policies can be reviewed and increased over time.

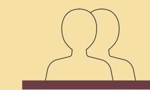
Term insurance

Term insurance will pay out only if you die during the term of the policy. This can be useful if you've gifted money during your lifetime which is subject to the seven-year rule. You can make sure that if you die within the seven-year period, any inheritance tax liability can be covered by the term insurance.

6. Using trusts

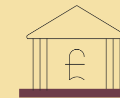
Trusts are often used to reduce any inheritance tax liability. A trust is created when the person who establishes the trust, the "settlor", transfers an asset (such as money, land or buildings), and appoints trustees to manage the asset in accordance with the trust rules for the benefit of a third party (the beneficiary).

Despite perceptions to the contrary, inheritance tax is sometimes payable on assets held under trust, depending on the type of trust.



Bare trusts

This is the simplest type of trust. It's commonly used to transfer assets to children, where the settlor doesn't want the beneficiary to take control until they are 18 (there is a legal right to ownership of assets at 18 in a bare trust). Assets transferred this way are considered "potentially exempt transfers", so there is no inheritance tax to pay if the settlor survives for seven years.



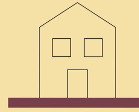
Discretionary trusts

This is a popular trust form for inheritance tax planning. Often used for children and grandchildren, the trustees have discretion about how to distribute funds after your death. No beneficiary has an absolute right to income or assets from the trust. As the assets are held in trust, they are not charged as part of your estate, so long as you live for a further seven years. However, inheritance tax may still be payable.

The detail provided above is intended to provide a high-level informative summary of inheritance tax charges that may apply to Trusting at the time of publication, and therefore should not be read as advice. Please consult a tax adviser for personalised advice that takes into account your specific circumstances.

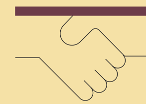
Discounted gift trusts

In this type of trust, the settlor makes a gift to the trust, but with conditions. The conditions are that the settlor retains the rights to pre-agreed payments of capital. The value of the gift is discounted to reflect the pre-agreed payments of capital based on the settlor's age, sex and health. This approach means that the value of the settlor's estate is reduced by the "discount", but the settlor still receives the pre-determined payments. This type of trust is often used for insurance bonds where the settlor retains the right to the 5% per annum income payments (which are tax-advantaged within insurance bonds).



Interest in possession trust

An interest in possession trust, commonly gives someone the right to live in a property or receive an income from investments, without ownership of the underlying assets, which are ultimately intended to pass to someone else. They are typically used in second marriages where the assets, perhaps a property or an investment portfolio, are intended to eventually pass to children from the first marriage, but the partner (often referred to as the Life Tenant) has the right to remain in the property or receive an income during their lifetime. The assets are considered part of the estate of the surviving Life Tenant, so are not included in the estate of the deceased.



Loan trusts

With a loan trust, rather than making a gift, the settlor lends money to the trust. In turn, the trustees invest the money for the benefit of the beneficiaries. The settlor can ask for part or full repayment of the loan at any time. This type of trust is typically used when someone doesn't feel comfortable about gifting capital, in case they need it in the future. A loan trust means any investment growth on the loan is outside the estate. Any loan repayments that are subsequently spent, further reduce any inheritance tax liability.

Charges for assets in trust

20%

INITIAL CHARGES

A 20% charge is applied when the assets are put into the trust, on the value of the assets in excess of the nil-rate band allowance of £325,000, assuming the nil-rate band allowance hasn't already been used.

6%

PERIODIC CHARGES

A periodic charge up to 6% is made every ten years, based on the current value of the assets at that time. Again, the nil-rate band allowance can be deducted before any charges are payable (if this hasn't already been used).

3%

EXIT CHARGES

There's also an exit charge when the assets are removed from the trust. This is also up to 6% based on the last valuation of assets, but pro-rated from the date of the previous ten-year periodic charge. So if the last periodic charge was five years ago, the exit charge would be 3%. A different basis is used if assets are removed in the first ten years.

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Business Relief

There's one other area of inheritance tax planning to consider: Business Relief. If inheritance tax were payable in these circumstances, some businesses would not survive.

Business Relief safeguards Small and Medium Enterprises (SMEs), which are crucial to the UK economy, as they employ more than 16 million people and account for 61% of our workforce.[1]

The Alternative Investment Market (AIM) is the London Stock Exchange's market for smaller, growing companies from the UK and across the globe. AIM is the world's most successful and established market for dynamic high-growth companies. In 1995, AIM launched with ten companies valued at £82 million. Today, AIM is home to around 810 companies, with a total market value over £95 billion.[2]

You can invest in companies which qualify for Business Relief and after a two year holding period, so long as you hold your shares in the qualifying company at death, the value of your investment (including any growth) may be exempt from inheritance tax.

What companies can you invest in that qualify for Business Relief?

A business must not be listed on a main stock exchange to qualify for Business Relief. Shares in unquoted companies, companies listed on the Alternative Investment Market (AIM), and even an entire family business being passed to the next generation, can qualify. However, the business must be a trading business. In practice, this means less than 50% of the business's activities should consist of investment activities, like buying stocks and shares, or land and buildings.

Business Relief can play a key role in inheritance tax planning. Even if you don't own your own business, you can invest in companies that qualify for Business Relief.

How long must you own the shares in the qualifying business?

To qualify for Business Relief, the business or business assets must have been owned for at least two of the previous five years before death. The exception is assets inherited from a spouse or civil partner. In this case, the spouse or civil partner "inherits" the period of ownership of their partner.

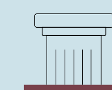
Private trading companies and AIM listed companies

Companies that may qualify for Business Relief may be either private trading companies or may be admitted for trading as an AIM listed company on the London Stock Exchange. Not all companies qualify for Business Relief so it is important to seek advice as to whether an investment will qualify.

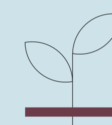
[1] www.fsb.org.uk, UK Small Business Statistics, 2021
[2] London Stock Exchange, 28 February 2023, https://www.londonstockexchange.com/reports?tab=aim

Benefits of Business Relief

Unlike "gifting" assets, you retain full control over your money.

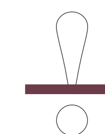


Your assets can become exempt from inheritance tax after two years, much quicker than gifts.



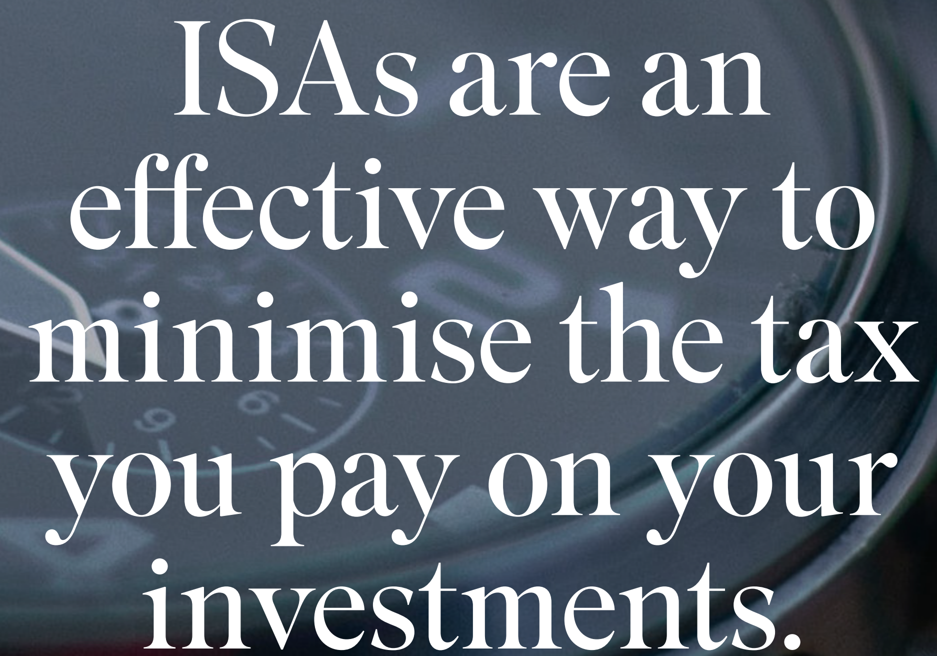
There is often potential for the assets to grow, although they can fall in value too.

It can be much simpler to invest in companies that qualify for Business Relief compared to setting up trusts, for example.



Of course, investing in AIM listed and unquoted companies does carry risk. Shares can be more volatile than shares in quoted companies, and more difficult to sell. Your capital is at risk, and you could get less back than your original investment. Tax rules may change, which could affect the tax reliefs available, and tax reliefs are subject to an individual's personal circumstances.

Finally, there is no guarantee that such investments will qualify for Business Relief, as it does depend on the companies retaining their qualifying status over the relevant period.



Business Relief via an ISA

With ISAs there is no income tax or capital gains tax payable.

You can invest up to the annual limit each year (up to £20,000 for the 2023/24 tax year) and there are no limits on how much you can withdraw. If you withdraw you cannot re-top up with already used allowance in current or previous years.

However, ISAs form part of your estate on death and are liable to inheritance tax. Although there is one exception - an ISA can effectively be transferred to your spouse or civil partner on your death. However, when they die, it will form part of their estate.

In 2013, new rules introduced the option to hold AIM shares in a stocks and shares ISA. This means if you invest in AIM companies that qualify for Business Relief, and you hold the shares for two years, you can leave your ISA on your death completely free of any liability to inheritance tax. That means there's no capital gains tax to pay on any growth on your investment, no income tax payable on any money you withdraw, and no inheritance tax payable on your death.

Your inheritance tax checklist

Work out how much your estate is worth:

£ ______ Property

£ ______ Savings (including your ISAs)

£ ______ Investments (not including your pensions)

£ ______ Other assets

£ ______ Life insurance (not in trust)

£ ______ Any likely inheritance from others

Work out how much you owe:

£ ______ Mortgage

£ ______ Loans

£ ______ Credit card debts

£ ______ Overdraft

£ ______ Any other financial obligations

£ ______ Net worth

If you think your estate could trigger an inheritance tax bill, you should consider talking to a financial adviser.

Take this checklist along with you and have a think about the ways you might consider planning for inheritance tax:

- [ ] Spend it, or give it away
- [ ] Insure it
- [ ] Put it into a trust
- [ ] Make investments that can help to mitigate your inheritance tax bill

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We're here to help

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If you have any other questions contact us on **020 7408 4100** or email us at **investorsupport@pumainvestments.co.uk**

For further information, please visit **www.pumainvestments.co.uk**

Cassini House
57 St James's Street
London SW1A 1LD

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