TECHTALK

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SCOTTISH WIDOWS

EDITOR

Sandra Hogg

Sandra is the senior tax manager within Scottish Widows with 17 years of hands on experience dealing with HMRC and advising owner managed businesses as an accountant and tax adviser. She also has over 18 years insurance industry experience as a financial planning expert within the group. She represents Scottish Widows at industry forums and at the ABI's Life Insurance Product Tax Panel and is Scottish Widows' expert spokesperson on Tax and Financial Planning.

CONTRIBUTORS

Jeremy Branton

Jeremy has over 25 years experience working for financial services providers in a number of technical and advisory roles in life, pensions and protection. Having joined the group in 2006 he now specialises in corporate pensions, with particular focus on pensions reform.

Bernadette Lewis

Bernadette joined the group in 2006. She has over 35 years experience in financial services with both providers and intermediaries. She has broad and deep technical experience across pensions, protection, tax and trusts.

Johnny Timpson

Johnny Timpson is Scottish Widows' protection specialist. Johnny is a member of the Income Protection Task Force, a member of the IPTF Welfare Working Group and is also a member of the Seven Families initiative project team. He is also a member of the ABI Protection committee, the CII Insuring Women's Futures Programme and chair of TISA's Consumer Protection Policy Council.

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WELCOME TO THE OCTOBER 2016 EDITION OF TECHTALK

Welcome to this Protection Special edition of Techtalk, covering a range of subjects from in depth specialist points to be aware of to broader planning considerations.

I'm pleased to welcome back our protection specialist Johnny Timpson as a guest author for this edition. Johnny covers three important protection topics for us.

First, citing recent research on the potentially dire financial consequences of a cancer diagnosis, Johnny tells us why he thinks it's so important to broach the need for critical illness protection with clients. Secondly, he reminds us about the benefit cap reduction due to take effect from 7 November 2016. And in his third article, he reviews the progress and achievements of the Seven Families project and considers what could be done next to address the UK's growing protection need.

The IT contractor is a growing business type. Many IT contractors will be operating as a single owner director company. I consider specific areas of interest for this type of business, focussing in particular on protection needs and profit extraction planning.

Protection policies are frequently set up in trust so that inheritance tax for the recipient can be minimised. They are also taken out to cover inheritance tax bills that could potentially arise out of lifetime gifts into trust. So, Jeremy and Bernadette have brought together a collection of articles covering protection and estate planning.

Jeremy covers discretionary trust ten year anniversary inheritance tax charges. Many trustees will shortly be facing these charges for the first time since the seismic changes that were made to inheritance tax in 2006. These charges can occur even where the only trust asset is a protection policy. He also reminds us about the importance of Lasting Powers of Attorney, and their equivalents in Scotland and Northern Ireland, and why planning for mental or physical incapacity should sit alongside any planning for ill health or unexpected death.

Bernadette explains that care should be taken in choosing trustees and looks at the importance of carrying out regular reviews. And in a holistic look at planning, she revisits the generous pension death benefits rules and reminds us why protection should be a keystone for inheritance tax planning. Finally she explains how to use protection policies to cover potential inheritance tax bills arising out of lifetime gifts.

I hope you'll find that this Protection Special edition will be a useful addition to your technical library. For more information on these and other protection topics please speak to your usual Scottish Widows contact or take a look at our extensive range of support at: **www.scottishwidows.co.uk/Extranet/Literature/Category/644** and **www.scottishwidows.co.uk/extranet/products/protection**

Enjoy the read.

Sandra Hogg

HEALTH, WEALTH… AND FINANCIAL RESILIENCE

Johnny Timpson

August of this year marked the 33rd anniversary of critical illness insurance, invented by a personal friend of mine, Dr Marius Barnard, a pioneering South African heart transplant surgeon.

Marius was very aware that medical advances and resulting improvements to both survival rates and life expectancy would significantly challenge the health, social care and welfare budgets and resources of Governments plus the financial resources of individuals and families as they faced into the costs of survival and provision of care. In many cases, whilst individuals are living with and beyond critical and life changing health events, due to their treatment (and in many cases its side effects) and ongoing care needs, their ability to earn income at pre health event levels is greatly impaired. Motivated by the financial hardship due to the costs of survival that he witnessed his patients suffer, Marius convinced Crusader Life in South Africa to introduce a new type of insurance, one that paid a benefit on the diagnosis of a critical health event and not the resulting death from it, so, in 1983, critical illness cover as we know it today was born.

In the years that followed, critical illness insurance was developed by insurance companies around the world with thousands of people every year having been able to survive financially as a result of it.

Very sadly, Marius, who had been driving the continued development of critical illness over the years, died of cancer in November 2014, and he passed the baton to us and we must carry it forward.

Scottish Widows' own research shows that fewer than one in 10 of the UK population have critical illness insurance, and more than a third admit they'd resort to dipping into their savings if they found themselves in a position where they or their partner were unable to work. This means there are an alarming number of families who could face a significant financial struggle in the event of an unexpected loss of income due to serious illness.

I'm regularly asked by advisers about how they can broach the need for protection with clients.

Using cancer as an ice-breaker may not seem like the most appropriate way to do this, but when you look at recent research and insight from Macmillan Cancer Support, it gives a rather big reason to have a financial resilience discussion with clients, both old and new. And it's not all negative.

Macmillan's 'Cancer: Then and Now' report published in late August, celebrates advances in cancer treatment and care, with people, on average, now twice as likely to survive at least 10 years after being diagnosed with cancer than they were at the start of the 1970s.

These improvements in survival are partly due to earlier diagnosis as well as more refined treatment, and as a result, more than 170,000 people are living with cancer in the UK who were diagnosed in the 1970s and 1980s.

This is positive news, but according to Macmillan, there are 625,000 people in the UK estimated to be facing poor health or disability after treatment for cancer.

And with the numbers of people living with the disease set to grow from 2.5 million to 4 million individuals by 2030, more people than ever will need support with the long-term effects.

Jane Maher, chief medical officer at Macmillan Cancer Support, argues that while cancer is not always life-ending, it's life-changing.

We need to ensure that people who have had the disease or who are living with it have a good quality of life and tailored, appropriate support.

I couldn't agree more. And critical illness cover is essential to this being possible.

It provides a significant financial boost at a time of emotional stress and financial difficulty, and can really help families who are struggling to come to terms with the impact of the disease.

As the rate of cancer survival improves, the need for financial protection becomes increasingly strong.

Research from Macmillan Cancer Support has also revealed that four in five people are, on average, £570 a month worse off as a result of their cancer diagnosis.

Scottish Widows, as just one example, paid out a total of £79.1 million in critical illness claims in 2015, helping thousands of individuals, and their families, to cope with the financial and emotional impact of a serious illness.

This demonstrates the true value of taking out appropriate cover. Cancer was the biggest reason for claims, accounting for 74% of claims by women (of which 50% were due to breast cancer) and 52% of claims by men.

It's astonishing, therefore, that so few people have financial protection.

And at a time when welfare reform is resulting in significant changes to benefits such as working age income replacement and housing support, which is the only financial back-up for many plus the overall benefit cap for households is being reduced with effect from 7 November 2016, families should consider reviewing their level of financial resilience and take appropriate advice on what they can do to protect themselves in the event that the unexpected happens.

IF THE CAP FITS... BUT WHAT IF IT DOESN'T?

Johnny Timpson

The benefit cap reduction with effect from 7 November 2016 and a DWP mailing offer the opportunity to discuss family financial resilience and protection needs.

As the nation shared in the success of Team GB in Rio, the Department of Work and Pensions (DWP) confirmed that a reduction to the household benefit cap is to be introduced with effect from 7 November 2016. From this date, the cap will be:

- £442.31 per week if you are a couple or have a child and live in London
- £384.62 per week if you are a couple or have a child and live outside London
- £296.35 per week if you are a single person living in London
- £257.69 per week if you are a single person living outside London.

The working age welfare benefits covered by the cap are – child benefit, child tax credit, housing benefit, incapacity benefit, income support, jobseeker's allowance, employment and support allowance (except for those in the support group), maternity allowance, severe disablement allowance and bereavement benefits. This is of particular relevance to clients with a mortgage, as jobseeker's allowance and employment and support allowance are capped by default – support for mortgage interest benefit is too and would contribute to their household benefit cap!

From 19 September 2016, the DWP is progressively mailing the millions of households and families who may be impacted by the benefit cap. This offers an opportunity to engage with clients on the benefits of improved financial resilience and appropriate financial protection advice, especially if clients are renting in a desirable post-code /school catchment area and/or have a mortgage.

To aid advisers engage clients on the benefit cap, working age welfare reform and the benefits of improved financial resilience and appropriate advice, see the support available from the Seven Families project at **www.7families.co.uk** and especially the 'How finvincible are you?' tool. Details of the working age welfare benefits mentioned above can be found at **www.disabilityrightsuk.org** and **www.turn2us.org.uk**

PLANNING CONSIDERATIONS FOR IT CONTRACTORS

Sandra Hogg

Initial jobs data relating entirely to the period immediately after the EU Referendum vote indicates a marked increase in IT roles. Figures from Reed show that almost 12,000 IT jobs were added to the recruiter's website in the three weeks following 24 June 2016.

This represents a 14% jump on the same period in 2015 when approximately 10,500 new IT jobs were added to the site, according to figures obtained by ContractorUK*.

We take a look at a few of the planning considerations impacting IT contractors, using a case study.

*Source: **www.contractoruk.com** Job News & Guides Jul 22, 2016

HARRY

Harry had been employed by an insurance company for twenty years, before he was made redundant in September 2014. Harry's redundancy payment was £50,000, after tax. He's in his mid forties, and is married with two children aged ten and twelve. After six months he was offered work as an IT contractor, with Computing Personnel Ltd, and started 1 April 2015.

As a contractor he had to consider whether to establish his business as a limited company or whether to join the umbrella structure offered by Computing Personnel Ltd.

An umbrella structure lends itself well to someone on short term contracts, as it's very easy to use. The individual would simply enter their timesheet and expense details and wait to be paid. The umbrella will invoice the client, and if necessary, chase up payment. All tax and national insurance (NI) would be deducted before the individual receives their money, so they wouldn't normally have any further tax to pay. However, umbrella structures normally charge a fee to be used.

A limited company structure involves set up costs and more paperwork. However, as Harry intends to work as a contractor for a number of years he decided it would be worthwhile to set up his business as a limited company. He named his company Harry H Ltd.

A limited company is the most tax efficient structure, because of the ability to decide how much to pay yourself, a combination of salary and dividends, effectively avoiding NI.

Recently introduced restrictions on the ability to deduct travel and subsistence expenditure can impact both structures. Nevertheless, Harry can potentially claim a wider range of expenses than allowed under an umbrella scheme, and he gets to keep complete control of his financial affairs meaning he doesn't have to risk his money with any third party administrator. The types of expenses that could be deducted for tax purposes include: travel and subsistence, hardware and software, training, professional subscriptions, business telephone, accountancy fees and so on.

As Harry chose the limited company route he will need to be careful not to fall foul of IR35.

WHAT'S IR35?

It's tax legislation that's aimed at identifying individuals who, in the view of HMRC, are avoiding paying tax and NI by supplying their services to clients via a structure such as their own company, when the individual is acting like and is being treated like an employee of the end client.

Its effect is to severely restrict the tax breaks, ensuring that individuals cannot avoid PAYE by remunerating themselves by dividend. If caught by IR35, the individual is required to deduct PAYE and NI from any of their company's income that they haven't already drawn out as salary. This deemed payment of salary is a special calculation that allows tax relief for certain expenses.

However, since 6 April 2016, the cost of travel from home to and from affected workplaces is no longer an allowable deduction.

Normally, tax relief is available for travel and subsistence expenses for travel to and from a worker's home to a temporary workplace, but not for ordinary commuting, eg from home to a permanent workplace. From 6 April 2016, each assignment for a worker who is caught by IR35, or who is otherwise under the supervision, direction or control of the client, is considered to be a separate employment, ie a permanent workplace.

The first things Harry had to do after forming the limited company and opening a business bank account, were to ensure that he had covered himself and his company against potential liabilities, for example by taking out suitable professional indemnity, public liability and employer liability insurance.

Harry's had a number of different contracts, paying £300 per day. He works for 200 days a year, so that's the equivalent of £60,000 a year.

He's been so busy that he hasn't reviewed his financial affairs for some time and now feels that he urgently needs to replace the benefits he was used to having provided by his former employer: cover for death in service and contributions to his pension.

Let's look at these in turn.

COVER FOR DEATH IN SERVICE

His previous employer provided him with a death in service benefit via a group life scheme on a registered pension scheme basis. However, pension legislation applies to registered group life schemes which means that when benefits become payable, they are assessed against the lifetime allowance with the employee's pension funds. A tax charge of up to 55% will apply if the limit is breached, significantly depleting the funds available to the employee's dependants.

The good news for Harry is that he can now set up his own death in service cover, using a type of policy known as 'Relevant Life' that won't impact his lifetime allowance (LTA). Consequently only his pension would be assessable against the LTA in the event of his death, avoiding a tax liability.

The policy would have to be set up by his limited company Harry H Ltd. Employer contributions will be deductible against corporation tax. They are also tax efficient for Harry as the employee, because the employer's contributions aren't treated as benefits in kind, nor are they assessable for employer or employee NI.

A relevant life policy (RLP) provides an alternative way for an employer to set up life cover for its employees which is still tax efficient, but without the possibility of triggering an LTA tax charge.

To be eligible, the life assured must be an employee of the business, including directors taxed on an employment income basis. Employees of LLPs, partnerships and sole traders are also eligible but not the business principals themselves.

How do they work?

- The employer takes out an RLP on the life of an employee.
- The policy is issued from the outset under a relevant life policy trust for the benefit of the employee and their family and other named individual beneficiaries.
- The initial trustee will normally be the employer but other trustees may be appointed.
- Premiums are paid by the employer.
- In the event of a claim the benefits will be payable to the trustees.

An RLP must also meet certain conditions:

- The policy can only pay out on death or upon diagnosis of a terminal illness.
- The policy cannot provide a surrender value.
- The scheme cannot run past the employee's 75 birthday
- It can only pay benefits to an individual or to a charity.
- The main purpose of the policy cannot be tax avoidance.

The further good news for employees like Harry, who run their own company and take low salary and high dividends for tax planning reasons, is that the life cover under an RLP doesn't have to be based on the low salary figure, it can be based on a fixed amount.

However, a single person business structure like Harry's can have implications for the shape of their business protection advice and cover needs, as summarised in the table below:

LIMITED COMPANY

A one-person limited company is a separate legal entity. It's a legal person in the same way as a living individual.

In their capacity as sole shareholder, the individual is the sole owner of the limited company.

In their capacity as sole director, the individual is an employee of the limited company.

Harry H Ltd is a limited company where Harry is the sole shareholding director.

Harry is the sole owner of this business.

RELEVANT LIFE COVER

It is possible to set up relevant life cover for the director of a limited company, as they have employee status.

Note that with relevant life cover the limited company (not the director) would be the applicant for the relevant life policy and the settlor of the relevant life policy trust. The director would be the life assured.

FAMILY PROTECTION – OTHER

The sole owner of a business is likely to have significant personal and family protection needs. A family trust can be used where relevant in respect of any personal term or whole of life insurance cover.

For example, Harry should consider what happens if his wife dies or becomes seriously ill. As a contractor, taking time off work for school holidays, doctors/dentists and so on is going to come straight out of his daily rate - he's given up on paid holidays. So reviewing her life assurance cover and setting up an ordinary level term assurance policy in trust while the children are likely to be dependant might be a priority.

BUSINESS TRUST

A business trust is not suitable as there are no shareholder or partnership protection needs because there are no co-owners in this business structure.

If Harry H Ltd operates an overdraft or has other borrowing, the lender might require it to set up life cover on Harry's life to ensure the lending could be repaid in the event of his death. If so, the policy should be set up on a life of another basis, with Harry H Ltd as the applicant and Harry as the life assured. No trust is required.

The lender provides its own mortgage assignment, which is completed once the policy is in force, and it is the lender which gives notice of its interest in the policy to the provider.

PENSION FUNDING

Harry has already built up £600,000 in a money purchase pension scheme with his previous employer and he wants to continue to build additional pension benefits. He'll have a £40,000 pension annual allowance, provided he keeps his income below the £150,000 threshold at which tapering of the annual allowances kicks in.

Harry is an employee of Harry H Ltd. Any employer contributions from his company Harry H Ltd should benefit from corporation tax relief. Personal contributions can benefit from tax relief up to the greater of £3,600 gross or his relevant UK earnings.

Harry and his accountant worked out how best to remunerate him from his company, and in 2015/2016 he took £8,060 as salary and £34,940 as dividends.

It's important that Harry doesn't take more dividends than is allowed. He mustn't take more than Harry H Ltd's distributable profit. To do this he has to consider how much his company's expenses will be. He can top up his income with further dividends later once he is certain how much distributable profit is available.

The taxation of dividends changed from 2016/2017. Are they still tax efficient for Harry? Can pension funding be more tax efficient?

DIVIDEND TAX

The introduction of a tax-free dividend allowance, the removal of the 10% dividend tax credit and an increase in the dividend tax rate can make dividends more expensive.

The dividend allowance exempts the first £5,000 of dividends from income tax, irrespective of what tax band they fall in. The exempted dividends, however, will still use up part of the relevant tax band. The removal of the tax credit means there is now no distinction between net and gross dividends – so all dividends are paid and received gross and it is this amount that must be entered into the self-assessment tax return.

The previous dividend tax rates of 10%, 32.5% and 37.5% have now become 7.5%, 32.5% and 38.1% for basic, higher and additional rate taxpayers. This represents an increase of 7.5% in the effective rate of tax as the previous rates were applied to the grossed up dividend not the actual dividend received. The previous effective rates of tax were: 0%, 25% and 30.6%. Adding 7.5% to each of these gives you the new rates. It is, therefore, the £5,000 dividend allowance not the new tax rates that results in many taxpayers being better off since 6 April 2016.

Dividends below £5,000 per year will now suffer no tax even though the dividend will be included in the income tax calculation. Dividends of any amount received in previous years could have been taxed at 10%, 32.5% or 37.5%, so the new rules are an improvement for those in receipt of low levels of dividends. If those dividends would previously have been taxed at 10% and covered entirely by the tax credit, then there is no improvement in the tax liability but their position has improved marginally as the dividend now uses up less of their tax band as it is not grossed up.

Higher and additional rate taxpayers can receive moderate levels of dividends and still be better off under the new rules. The point at which the new dividend rules result in more tax will be usually be specific for each client, but a useful guide for higher and additional rate taxpayers with dividends that sit entirely in those tax bands is that the crossover point will be reached at the following dividend levels:

Higher rate taxpayers:	£21,667
Additional rate taxpayers:	£25,250

An increase in tax is much more likely to apply to those who own their own companies and have decided to pay themselves in dividends rather than salary. If the new dividend tax rules are less favourable they may want to consider paying the maximum employer pension contribution instead of a part (or all) of the dividend. If the new rules are more favourable, then swapping any salary they receive for dividends might appeal more.

Let's look at a comparison between the old rules and the new for Harry.

Harry's company pays him a salary of £8,060, so that he can avoid paying NI, but will still qualify for NI based benefits, and dividends of £34,940. He has no other sources of income. What is his tax liability under the new dividend taxation regime compared with the previous tax year?

The calculation for this year and last year, keeping the income level constant, is:

2015/2016		2016/2017	
Salary	£8,060	Salary	£8,060
Dividends	(£34,940/0.9) £38,822	Dividends	£34,940
Total income	**£46,882**	**Total income**	**£43,000**
Full personal allowance available:	£10,600	Full personal allowance available:	£11,000

EARNED INCOME		DIVIDENDS		EARNED INCOME		DIVIDENDS	
Salary	£8,060	Dividend	£38,822	Salary	£8,060	Dividend	£34,940
Deduct PA	(£8,060)	Deduct PA	(£2,540)	Deduct PA	(£8,060)	Deduct PA	(£2,940)
						Divi allowance	(£5,000)
Taxable	**£0**	**Taxable**	**£36,282**	**Taxable**	**£0**	**Taxable**	**£27,000**
		Basic rate tax: £31,785 x 10% = £3,179				Basic rate tax: £27,000 x 7.5% = £2,025	
		Higher rate tax: £4,497 x 32.5% = £1,461				**Tax due**	**£2,025**
		Total tax	**£4,640**				
		Less tax credit	(£3,628)				
		Tax due	**£1,012**				

THE PENSION SOLUTION

The increased tax bill should motivate Harry to consider the most tax-efficient way to remunerate himself. The clearest way to do this is to consider the total cost to the company of his remuneration package and the net benefit to himself, which can be expressed through an 'extraction rate'.

The total cost to the company of Harry's current package is £51,735, which is made up of £8,060 salary and the £34,940 dividend grossed up at the rate of 20% to include the corporation tax due against the dividend.

Switching to 100% salary wouldn't improve his position because employer NI of £5,290: ([£51,735 - £8,112] x 13.8%/113.8%) reduces the amount that can be distributed as salary whilst keeping the overall cost to the company constant. The personal tax bill – made up of income tax and employee NI – would be £12,040. This results in a total income tax and NI bill of £17,330, leaving £34,405 net, which is significantly less in pure tax terms than the net amount available through Harry's dividend-based remuneration package.

		SALARY	DIVIDEND
Contract		£60,000	£60,000
Expenses		(£8,265)	(£8,265)
		£51,735	£51,735
Salary		£46,445	£8,060
Employer NI @ 13.8% on £46,445 - £8,112 = £38,333		£5,290	
Income tax @ 20% on £32,000	£6,400		
Income tax @ 40% on £3,445	£1,378		
		(£7,778)	
Employee NI @ 12% on £34,940	£4,193		
Employee NI @ 2% on £3,445	£69		
		(£4,262)	
Net income / Profit		£34,405	£43,675
Corporation tax @ 20% on £43,675			(£8,735)
Distributable profit			£34,940
Dividend			£34,940
Income tax on dividend			(£2,025)
Net income		£34,405	£40,975

Switching to employer pension contributions of £51,735 – assuming at least £11,735 of carry forward is available – will not result in any immediate tax, but the potential tax to extract the funds from the pension has to be incorporated for a fair comparison. In other words, the potential future tax in retirement is brought forward to the present day and notionally applied to the contribution.

Assuming basic rate tax in retirement the potential tax charge is £7,760: 20% x (£51,735 x 75%). This would leave Harry with £43,975 net, which is more than the net amount available under the current strategy, but the trade-off is a potentially higher than expected tax bill (if income in retirement is higher than anticipated) and no immediate access to funds due to his age.

As Harry has an immediate need for income, then such a high employer contribution may not be suitable. However if he could supplement his income from his remaining redundancy money then a large employer contribution would be the most tax efficient solution for Harry. And as he becomes more experienced and his contract earnings rise he will be able to increase employer contributions year on year. He should consider paying as much in employer pension contributions as possible for retirement planning purposes, always being mindful of the lifetime allowance of course.

Otherwise, Harry is in a position where he potentially has the best remuneration strategy from a tax perspective, even though his position has worsened because of the new rates. In which case, he should continue to receive the small amount of salary and the dividends and suffer the slight increase in income tax.

The best outcome will be less clear cut for individuals with higher levels of income.

(This example is simplified slightly as in reality certain adjustments have to be made to the profit when calculating corporation tax.)

The Scottish Widows salary dividend pension calculator can be accessed from the Adviser website under **www.scottishwidows.co.uk/extranet/tools**

IT contractors have quite particular support needs and a potential boom in this industry could lead to a big increase in opportunities to provide good quality advice, for anyone who is willing to specialise in this area.

FROM SEVEN FAMILIES TO YOUR FAMILY...

Johnny Timpson

We're engaging clients and introducers through interactive storytelling, be it face-to-face, in the workplace, or online **www.7families.co.uk**

What we really wanted to do with the Seven Families project was to bring health and disability charities, individual and group protection providers, reinsurers and financial advisers together in common cause, in collaboration and under a single brand. With the aim to:

- raise consumer, adviser and influencer awareness of the financial impact of long term illness or disability
- help seven real and diverse working age families who were facing financial meltdown following a health breakdown
- demonstrate the value of financial resilience, independent living support, rehabilitation and counselling, through trying to help get people back to work.

WHY DID THE SEVEN FAMILIES PROJECT FOCUS PURELY ON RAISING AWARENESS AND RESILIENCE RATHER THAN PRODUCT PUSHING?

For too long as an industry our message has been seen as a thinly veiled attempt to sell more policies. With the British public suspicious of the industry's motives and confused by over complicated language, technical solutions and scary statistics. In recent years visceral protection advertising from a number of providers has managed to engage consumers' emotions and feelings. However, the Seven Families team wanted to truly make a difference. Health and disability charities detailed the needs presented to them in times of crisis and highlighted loss of ability to earn as a key issue. When people can't pay their bills every other aspect of their finances falls down like a house of cards, especially with savings levels at a historic low. And if the worst does happen, it can have disastrous financial consequences, impacting a person's ability to maintain their lifestyle and service commitments.

The project at no point focused on any specific type of product solution. However, it has been viewed by a number of journalists and advisers as an income protection campaign. This is not the case, as five of our seven families could have made critical illness claims and indeed one did. And whilst that family paid off their mortgage with their claim proceeds, they quickly had another issue, a significant reduction in income. The replacement level of benefit available from working age welfare was not enough for them to maintain their level of lifestyle. We viewed it important to focus simply on improving financial resilience and demonstrating the benefits and outcomes of appropriate protection advice, product solutions, support services and rehabilitation interventions, rather than discuss specific protection products. Detailed recommendations are an outcome of an advice process and dependent on each individual's circumstances.

Swiss Re's recently released Insurance Report and research from 'The Syndicate' continues to flag consumer mistrust in our industry and the perception of low levels of claim payments. PPI remains an issue and the public don't distinguish between different parts of the industry. The involvement of the insurance industry in the Seven Families initiative made some people suspicious. Which is precisely why we delivered the project devoid of any attempt to push insurance products. The publication of claims statistics is useful progress but we need to do more and highlight the ease of the claim process, speed of claim payment and the benefits of added value services such as RedArc and rehabilitation interventions. By highlighting these aspects and publicly supporting families with no strings attached, the project set out to demonstrate to consumers, the media and advisers the claims process and outcomes for real. And show how they could help real people.

The Seven Families project delivered more than its original objective, and it keeps on delivering.

The project continues to engage the industry on a number of key issues that we need to address:

- **Vulnerable customers and improving treatment, support and outcomes** – this issue has been the focus of Financial Conduct Authority (FCA) Occasional Papers number 8 and more recently 17. All of the seven families taking part in the project can be categorised as vulnerable and the video case studies serve as useful training material for advisers, business leaders and all staff serving and supporting vulnerable customers. The FCA has also highlighted the value of working with charities and the project has broken new ground for our industry by working in collaboration with the charity sector in common cause.
- **Inclusive diversity** – we've a record number of women in the workplace, establishing and leading their own businesses, as the sole and main bread winner in their households. But this is not mirrored in insurance coverage, despite us now witnessing the most significant reform of working age welfare since Beveridge, having a disproportional impact on women. The Chartered Insurance Institute (CII) has recently launched its Women In Insurance programme to address this issue. By having diversity at its core, the Seven Families project supports this, with the personal stories of four women involved in the project in its video material.
- **Working age welfare reform** – all seven families in the project thought that they could rely on the welfare state but have found it difficult to understand their entitlement, problematic and impersonal to claim, and the replacement level of benefits relative to their former level of income was low. Benefits were also conditional and in a number of instances means-tested, subject to a waiting period, time-boxed and capped.

- **House and home security** – with a significant number of mortgages unprotected and a growing number of those renting lacking savings or an income replacement contingency strategy it is key that we discuss improving home occupancy resilience. Especially with the welfare benefits supporting those mortgaged, in shared ownership or renting being reformed. The Seven Families material does this with a number of the families featured having faced or facing housing issues.
- **Improving customer outcomes** – whilst publishing claims statistics and monetary values is to be welcomed, the Seven Families project goes beyond this by bringing to life and showing the support and rehabilitation interventions that now form part of the care and claim services that can aid policyholders and their families.
- **Improving adviser use of social / workplace media, real case studies, interactive tools and storytelling** – the Seven Families collateral that advisers can freely use, plus the project's use of social media, radio, TV and consumer press (print and online) both supports advisers and provides an example of what can be done. It's pleasing to see that over the life span of the Seven Families project, the Intelliflo report shows that adviser usage of social media is up for the third year running, with 70% of advisers engaging with social media for business purposes. This is up from 58% in 2014 and 61% in 2015, and whilst we cannot attribute all of this to the project, Seven Families has played its part.

HOW DO WE BUILD ON SEVEN FAMILIES?

With the demise of the Money Advice Service and the ambition of the Financial Advice Markets Review (FAMR), it's key that the industry debates how we collaborate and work in common cause with others, such as health charities. The aim is to improve consumer awareness of the benefits of improved financial resilience plus appropriate protection advice, propositions, support services and rehabilitation interventions. The good news is that recent improvement in income protection sales and coverage is in part being attributed to the Seven Families initiative and raising consumer awareness is high on the agenda of our professional, industry and trade bodies.

WHAT COULD WE DO NEXT?

- Run another Seven Families type initiative and perhaps focus on some additional family financial resilience issues beyond loss of income. For example, looking at long term care needs and the benefits of a Lasting Power of Attorney.
- Take learnings from **www.lifehappens.org**, a not-for-profit adviser support hub in the US. Look at the national, month long, life and critical illness, income protection and long term care consumer awareness and education that they run. Lifehappens.org's branded social and worksite media material, tools and real video case studies are made available to advisers along with marketing consultancy if required.
- A combination of both – my personal preference.

To address the growing protection need in the UK and to protect Britain's national and family prosperity, we need to work together to better engage consumers, clients and introducers through interactive storytelling, conversation and gamification, be it face-to-face, in the workplace or online. Because, life does happen and in many cases, with financial consequences for our families.

DON'T FORGET YOUR ANNIVERSARY! 10 YEARLY CHARGES ON DISCRETIONARY TRUSTS

Jeremy Branton

The inheritance tax (IHT) treatment of trusts changed significantly in 2006. Ten years on and trustees of some of the first trusts created under the new regime will be facing their first periodic anniversary.

BACKGROUND

Before the 2006 IHT changes, discretionary trusts tended to be niche solutions created on a bespoke basis by legal advisers. Prior to 22 March 2006, the standard 'off the shelf' trust offered by many life offices for use with their life products was the flexible, power of appointment, interest in possession trust. This provided the flexibility to change beneficiaries to accommodate changes in circumstances without the trust being subject to the IHT treatment applying to discretionary trusts.

Generally speaking, these pre-22 March 2006 trusts remain outside the discretionary trust regime, although changes to beneficiaries and additions of funds outside specified criteria can cause them to become treated in the same way as discretionary trusts for IHT purposes.

BUDGET 2006 CHANGE

IHT changes introduced by Finance Act 2006 mean that most trusts offering flexibility set up on or after 22 March 2006 are subject to the 'relevant property' regime that applies to discretionary trusts. Legislation describes relevant property as settled property in which there is no qualifying interest in possession. So this applies to fully discretionary trusts, where there's a range of potential beneficiaries, and the trustees have discretionary powers to appoint the trust fund to any of them. It also applies to post 21 March 2006 flexible power of appointment, interest in possession trusts, where there are default beneficiaries as well as potential beneficiaries, with the trustees given discretionary powers to decide who eventually benefits.

Relevant property, which is any asset held in a discretionary trust or a trust taxed on the same basis as a discretionary trust, doesn't form part of a beneficiary's estate – instead a charge to IHT can apply when assets including cash or investments first enter the trust, at each 10 yearly anniversary of trust creation and where capital exits the trust. Capital exiting a trust includes bond withdrawals or life policy proceeds paid out to trust beneficiaries. There may also be a requirement to report to HMRC using an IHT 100 on each of these occasions.

VALUING THE TRUST AT THE FIRST 10 YEAR ANNIVERSARY

A periodic charge to IHT arises in respect of the value of relevant property held in a trust every ten years. The value of any relevant property held in trusts created by the settlor on the same day are also included, although this should be relatively rare in practice.

The tax rate is calculated using a standard formula giving rise to a maximum charge of 6% on the value of relevant property in the trust. Where available, business property relief and agricultural relief are deducted before applying the charge; however, this is unlikely to apply to assets held in a trust including an investment bond or life insurance policy.

The resulting taxable value is then reduced by the nil rate band in force at the 10 year anniversary less any chargeable lifetime transfers made by the settlor in the 7 years before establishing the trust. Any distributions made by the trustees prior to the 10 year anniversary are deducted. Once the exact rate has been determined, it will be applied to the current value of the relevant property held in the trust.

The formula:

	£	£
Current value of relevant property in trust immediately before the 10 year anniversary		X
Initial value of any relevant property held in any other trust created by the same settlor on the same date		X
		A
Nil rate band at the 10 year anniversary	X	
Less:		
Value of any chargeable transfers made by the settlor in the 7 years before the trust was set up		
	(X)	
Value of any distributions of relevant property out of the trust within the last 10 years	(X)	(X)
		B
B x current IHT lifetime rate of 20% = C		
Effective rate = C/A x 100		
Actual rate = effective rate x 30%		
IHT payable = Current value of relevant property x actual rate		

Anti-avoidance provisions now apply where same day additions are made to more than one settlement established by the same settlor, which can mean the settlements are effectively treated as related settlements for 10 year charge purposes.

EXAMPLE 1

Andrea set up a discretionary trust on 1 November 2006 transferring assets worth £250,000. She made a chargeable lifetime transfer of £35,000 two years previously. At the first 10 year anniversary, the trust fund is valued at £400,000 and the tax charge is calculated as follows:

10 YEAR ANNIVERSARY – 1 NOVEMBER 2016	£	£
Current value of relevant property in trust immediately before the 10 year anniversary		400,000
Initial value of any relevant property held in any other trust created by the same settlor on the same date		-
		400,000
Nil rate band at the 10 year anniversary	325,000	
Less:		
Value of any chargeable transfers made by the settlor in the 7 years before the trust was set up	(35,000)	
	-	
Value of any distributions of relevant property out of the trust within the last 10 years	-	
		(290,000)
		110,000

Applying these figures to the formula we get:

110,000 x 20% = 22,000

Effective rate = 22,000/400,000 x 100 = 5.5%

Actual rate = 5.5% x 30% = 1.65%

IHT payable = £400,000 x 1.65% = £6,600

PROTECTION POLICIES

Where a discretionary, flexible or other relevant property trust holds a whole of life or term assurance policy with no surrender value, a periodic charge could arise where a claim has arisen, the proceeds are still held by the trust at its 10 year anniversary and the trust value exceeds the available nil rate band. Otherwise a charge shouldn't arise unless the life assured is in serious ill health at or around the 10 year anniversary in which case HMRC may contend the policy has acquired an open market value close to the claim value leading to a potential charge.

DISCOUNTED GIFT TRUSTS

This type of trust allows an investor to make an IHT effective gift from their estate, while providing them with pre-determined, regular payments of capital. A discounted gift trust established on or after 22 March 2006 that provides the trustees with the discretion to make appointments from the trust – once the settlor's entitlement has been provided – will also be a relevant property trust. HMRC has issued specific guidance on how to value a discounted gift trust at a ten year anniversary and we summarise this in our related article:

http://www.scottishwidows.co.uk/Extranet/Literature/Doc/FP0422

CAPITAL EXITING THE TRUST FOLLOWING A 10 YEAR ANNIVERSARY CHARGE

Where trustees make a distribution of capital from the trust, the rate of IHT from the previous 10 year anniversary is applied to the number of complete 3 month periods between the previous 10 year anniversary and the date of the distribution.

EXAMPLE 2

Continuing with our first example, on 15 May 2020, Andrea and her co-trustees decide to distribute £25,000 out of the trust to one of the beneficiaries, Mary, who agrees to pay any IHT due.

As a charge to IHT arose at the previous ten year anniversary, the calculation will be as follows:

£25,000 x 1.65% x 14/40* = £144.37

Note where there has been a change in the nil rate band between a 10 year anniversary and a distribution from the trust, it will be necessary to recalculate the IHT rate.

* Number of quarters between 1 November 2016 and 15 May 2020.

VALUING THE TRUST AT THE NEXT 10 YEAR ANNIVERSARY

Ten years later the trust fund has grown to £525,000 and we'll assume the nil rate band is now £350,000.

EXAMPLE 3

10 YEAR ANNIVERSARY – 1 NOVEMBER 2026	£	£
Current value of relevant property in trust immediately before the 10 year anniversary		525,000
Initial value of any relevant property held in any other trust created by the same settlor on the same date		–
		525,000
Nil rate band at the 10 year anniversary	350,000	
Less:		
Value of any chargeable transfers made by the settlor in the 7 years before the trust was set up	(35,000)	
Value of any distributions of relevant property out of the trust within the last 10 years	(25,000)	(290,000)
		235,000

Again applying the same formula we get:

235,000 x 20% = 47,000

Effective rate = 47,000/525,000 x 100 = 8.95%

Actual rate = 8.95% x 30% = 2.685%

IHT payable = £525,000 x 2.685% = £14,096.25

HMRC REPORTING

The trustees may be required to submit an IHT 100 account to HMRC at a 10 year anniversary or where distributing capital from the trust. This is determined by whether the 'notional aggregate chargeable transfer' – a hypothetical chargeable transfer to determine whether a charge arises – is above 80% of the nil rate band. It's possible that an IHT 100 account will need to be filed with HMRC even if no IHT is actually payable.

The filing and payment dates in respect of 10 year anniversary and exit charges are now aligned at 6 months after the month in which the charge arose.

The trustees should refer to HMRC's IHT 110 'How to fill in form IHT 100' for assistance.

SUPPORT FOR TRUSTEES

Many relevant property trusts holding life policies will have been established with 'lay' trustees – family members and friends who may be unaware of the specific obligations that apply to the administration of relevant property trusts. Advisors can help by raising awareness of the specific requirements, recommending that professional taxation and legal advice is sought where appropriate.

TRUSTEES AND PROTECTORS: CHOOSE WITH CARE

Bernadette Lewis

When a settlor chooses their trustees and any protector, they need to ask themselves: 'Is this person trustworthy? And will they protect the trust assets for my intended trust beneficiaries?'

A REMINDER OF THE BASICS

Advisers generally deal with putting protection policies and investment bonds into trust. Putting this into context, a trust is any arrangement where someone gives one person funds or property to hold on someone else's behalf. Traditionally, a trust has three parties: the settlor, the trustee and the beneficiary. The settlor is whoever provides the funds or property. The trustee is the person holding the property. The beneficiary is the person the trustee is holding the property for. These days, many trusts also have a protector role, as explained below.

NUMBER OF TRUSTEES

Providers' standard trusts normally appoint the settlor as one of the trustees at the outset. Joint settlors are usually both trustees at the outset. Appointing additional trustees is sometimes obligatory and the trust document will specify when this applies. However, it's always sensible to appoint at least one additional trustee from the start.

If the settlor dies before the trust fund is fully distributed, this helps ensure there are personally chosen trustees in place. If the settlor dies and there are no remaining trustees, their legal personal representatives can normally appoint replacements. If so, the settlor won't have chosen the new trustees, so they're unlikely to be aware of the settlor's intentions for dealing with the trust fund.

For flexible and discretionary trusts, there must be at least two trustees in place before they can exercise their discretionary powers to appoint any of the trust fund to the beneficiaries. A trustee can retire so long as this leaves at least two individuals or a trust corporation in place. If not, another trustee must be appointed at the same time as a trustee retires.

TRUSTEES' DUTIES

Many protection policies are written in split trusts, where the settlor keeps the right to some of the possible payouts under the policy. For example, the right to any critical illness or terminal illness payments. The provider pays the claim to the trustees as legal owners of the policy, then the trustee pays the settlor or beneficiaries as required by the terms of the trust. Providers take slightly different approaches to what is and isn't covered by a split trust, so the trustees need to check the trust wording in each case.

Trusts are also used for inheritance tax planning involving investment bonds. If the trust is a loan trust, the trustees must repay any outstanding loan to the settlor on demand. The trustees are usually personally liable to repay any outstanding loan if there's a shortfall. With discounted gift trusts, the trustees must pay the settlor their regular income payments from the trust fund as they fall due.

After taking account of any settlor's rights, the trustees have an overriding duty of care towards the trust beneficiaries. The trustees are legally bound to act only in accordance with the trust terms. When a settlor is also a trustee, they have to put their own interests aside when dealing with the trust fund, even if their circumstances have changed since setting up the trust.

Trusts often incorporate a standard range of discretionary beneficiaries. The trustees have the power to appoint the trust fund to any of these beneficiaries. This applies to both fully discretionary trusts and flexible trusts with default beneficiaries. Naming a default beneficiary acts as an expression of wishes, but isn't binding on the trustees.

The discretionary beneficiaries usually include the settlor's children, grandchildren and remoter issue. Remoter issue are all the settlor's direct descendants. Often, the discretionary beneficiaries will also include the settlor's spouse/civil partner, siblings, nephews and nieces and their spouses/civil partners. It's usually possible to add to the beneficiary class. For example, if the settlor is cohabiting, they usually need to name their partner as a potential beneficiary as they won't have a legally defined relationship covered by the standard provisions.

With such a wide range of beneficiaries, the settlor will want to ensure the trustees understand their wishes for dealing with the trust fund. Do they want to benefit their grandchildren, perhaps including any born after the settlor's death? Is there a child the settlor doesn't wish to benefit? Perhaps because they are already well provided for, or because they've gone off the rails. Do they want the trustees to provide funds to beneficiaries when they reach legal adulthood, or delay access until they're more mature?

While the settlor is alive and one of the trustees, it's easy for them to discuss their thinking with the trustees. A settlor can also provide a non-binding letter of wishes to the trustees, so they remain aware of the settlor's wishes after their death. A letter of wishes can be amended at any time while the settlor is alive, to take account of changing circumstances. The settlor might also appoint a protector or successor protector and confide in that individual.

THE PROTECTOR

The concept of a protector originally developed for offshore trusts where a trust corporation is often the sole trustee, to ensure there's someone with knowledge of the settlor's intentions to guide the professional trustee. However, protectors are now more widely used.

The protector is not a trustee, although the same person is often both the protector and a trustee. The settlor usually appoints themselves as the first protector and can nominate their successor if they die or become legally incapacitated. Providers who incorporate protectors in their trusts usually offer forms to nominate successor protectors. There are normally trust provisions specifying how to appoint a protector in other circumstances.

As the protector's role isn't defined in law, specific trust terms set out their powers. Protectors can often veto the appointment of the trust fund to a beneficiary. They may be able to dismiss a trustee by giving them notice in writing, provided specified conditions are met. A settlor can confide in a protector in addition, or as an alternative, to providing a letter of wishes.

While appointing a protector is not essential for running a trust, having a protector in place may provide a solution to some of the difficulties that can arise over the lifetime of a trust. These include trustee disagreements, perhaps following a family dispute. This can cause problems as in English law, all the trustees must act unanimously.

If there's a protector in place, it may be possible to dismiss a trustee who's creating difficulties without needing to take legal action to resolve the matter. Some trusts without protectors also include specific provisions to dismiss a trustee.

REVIEW TRUSTEES FROM TIME TO TIME

Once someone's established a trust in respect of a life policy or insurance bond, the trustees are its legal owners. The provider will require the signatures of all the trustees when dealing with any death or maturity claims or before arranging any bond fund switches, withdrawals or surrenders.

Therefore, the settlor should keep in touch with all their trustees. There can be significant delays if the settlor or co-trustees can't trace a trustee when there's a policy claim. A protector isn't a solution, because they can't dismiss a trustee they don't have an address for. A provider normally expects the settlor or co-trustees to use their own resources to make contact or establish that a trustee has died. If this proves impossible, the settlor or co-trustees will usually need to seek legal advice on resolving the matter.

Settlors often appoint their spouse as an additional trustee. If they divorce, it's worth using the divorce negotiations to raise the issue of the soon to be ex-spouse resigning as a trustee. This may avoid the difficulties that can arise if an ex-spouse trustee becomes uncooperative in subsequent years, or the parties lose touch following a clean break settlement.

Another sensitive issue is when trustees are showing the early signs of losing their mental capacity to act in respect of complex financial matters. The simplest solution is for the trustee to resign while they still have the mental capacity to do so and to appoint a replacement at the same time. For trusts created in English law, it is possible to replace a mentally incapacitated trustee using statutory provisions, but this involves legal costs. It's not possible for a protector to dismiss a trustee who doesn't have the capacity to understand they've been dismissed from this role.

OVERSEAS RESIDENT TRUSTEES

The introduction of common reporting standards, requiring the sharing of tax information with overseas jurisdictions, means providers may be increasingly reluctant to accept overseas residents as trustees.

There are some situations when appointing an offshore trust corporation as a trustee may be advantageous. However, it's best to avoid appointing overseas resident individuals as trustees. This avoids practical problems such as delays in getting trust paperwork signed. More importantly, the concept developed in UK law that trustees are the legal but not the beneficial owners of the trust assets is not necessarily recognised by other legal and tax jurisdictions, which can cause tax and legal complications. Clients should seek their own legal and tax advice if they want to appoint overseas resident trustees.

HOLISTIC IHT PLANNING CONSIDERATIONS

Bernadette Lewis

Mainstream inheritance tax planning for UK domiciles: gifting and trusts, pension death benefits under the Freedom and Choice reforms and the IHT planning keystone – protection policies.

IS THERE AN IHT PROBLEM?

According to HMRC's latest statistics, approximately 3.4% of deaths in 2013/2014 led to an inheritance tax (IHT) liability , although those falling into financial advisers' target markets are clearly more likely to be affected than the general population. Whether someone seeking financial advice is bothered about their estate's potential IHT liability depends partly on who they want to inherit their assets and also their views on the tax. People don't always conform to expectations: a parent might be unconcerned about the value of their 'difficult' child's inheritance, while a childless person might be keen to provide for favourite nieces and nephews.

Anyone dying with a taxable estate below £325,000, the amount of the frozen IHT nil rate band up to 2020/2021, normally escapes an IHT charge. The transferrable nil rate band effectively doubles this to £650,000 for married couples and civil partners. This assumes the deceased didn't make any non-exempt lifetime gifts in the preceding seven years.

The new residence nil rate band applies from 2017/2018 and complex provisions mean anyone planning to rely on it is likely to need to review their will. It will start at £100,000 and increase in £25,000 steps each tax year to reach £175,000 in 2020/2021. The total nil rate band on death will then be up to £500,000 for individuals and up to £1 million on second death for spouses/ civil partners. While welcome, this does complicate IHT planning as the residence nil rate band won't be available for lifetime gifting. Also, it will be withdrawn at £1 for every £2 the value of the death estate, before reliefs such as business property relief (BPR) and agricultural property relief (APR), exceeds £2 million. The deceased needs to leave their own home, which they've occupied, directly to lineal descendants plus their spouses or civil partners, which excludes most trusts. Special provisions apply to those who've downsized or sold their home after 7 July 2015.

A UK domiciled individual's IHT death estate includes their worldwide assets, their share of jointly owned property, and the value of their share in any qualifying interest in possession trusts. Any liabilities repaid from their estate are normally deductible. However, restrictions apply to some borrowing linked to IHT advantaged assets, such as those benefitting from BPR or APR.

Where the taxable estate exceeds the total available standard and residence nil rate bands, IHT is normally payable at 40% on the excess. However, the rate reduces to 36% if the deceased leaves at least 10% of their net estate to a recognised charity.

BPR, APR and similar reliefs at 100% or 50% (depending on the assets) might reduce the IHT liability on death. It's worth checking that any shareholder or partnership protection planning uses double/cross option agreements, rather than buy and sell agreements, to keep BPR available.

LET'S GET MARRIED!

Cohabitees can't benefit from the inter-spouse/ civil partner IHT exemption. All assets inherited by the survivor from the first to die's IHT estate constitute a non-exempt transfer, whether the deceased owned these assets outright, on a joint tenant or a tenant in common basis. In addition, cohabitees don't benefit from the transferable standard and residence nil rate bands. So there could be IHT to pay on both first and second deaths. Spending on a wedding could solve this problem and be an enjoyable way of reducing cohabitees' wealth! But protection policies in trust may be the realistic solution.

SPEND IT? OR GIVE IT AWAY?

Most people concerned about IHT have assets such as the family home and emergency cash they require full access to during their lifetime. They may also have plans for significant spending on experiences, or their own choice of support services if their health deteriorates. Allowing for this, some people have wealth well above amounts they're likely to need that they can safely give away. Still others have wealth they'd consider using in IHT planning, but fear needing in the future. Analysing whether these people actually need access to capital or income, and why, might point to ways they can include these funds in their IHT planning.

WON'T NEED

If someone has wealth they won't need, the most effective strategy is giving it away using immediate exemptions and/ or surviving for seven years. Some people can significantly reduce their estate's eventual IHT liability by making multiple lifetime gifts over an extended period.

When couples make joint gifts, for IHT purposes each of them is treated as making their own gift out of their own funds or their own share of joint funds. Each of them has their own nil rate band and any advice needs to consider each individual's own history of gifting.

- The small gifts allowance covers outright lifetime gifts of up to £250 each to any number of different individuals in a tax year.
- The £3,000 annual exemption can be used on its own, or to cover part of larger lifetime gifts, including potentially exempt transfers (PETs) and chargeable lifetime transfers (CLTs). Once someone's used the current tax year's annual exemption, they can bring forward any unused amount from the previous year. So gifts up to £6,000, or £12,000 for couples, might be immediately exempt.
- It's possible to combine other lifetime exemptions, such as the various limits on gifts in respect of marriage or civil partnership, with the annual exemption.
- Individuals can also make exempt gifts to charities, political parties and for the national benefit - in this case, both in lifetime and on death.
- The normal expenditure out of income exemption requires establishing a regular pattern of lifetime giving over a number of years, using someone's current year's income without affecting their standard of living. It's particularly useful for covering regular premiums on protection policies written in trust to cover IHT.

The non-exempt part of any lifetime gift is a potentially exempt transfer (PET) or chargeable lifetime transfer (CLT) and falls outside the donor's IHT estate provided they survive for more than seven years.

Outright gifts to individuals and bare trusts are PETs and there's no immediate IHT charge, no matter how large the gift.

Transfers into flexible and discretionary trusts are CLTs. These trusts allow the settlor to retain some control by being a trustee and can also protect funds in the event of the death, divorce or debts of the potential beneficiaries. A lifetime IHT charge applies if the non-exempt amount exceeds the donor's available nil rate band, which is reduced by the running total of their CLTs (if any) in the previous seven years. The lifetime rate is 20% on the excess if the donor pays and effectively 25% if the trustees pay. In addition, IHT periodic and exit charges, and IHT 100 reporting requirements all apply to discretionary trusts. There's also special tax treatment for trust income, capital gains and bond chargeable event gains.

If the donor dies within seven years, the failed PET or CLT reduces the amount of standard nil rate band available to set against the donor's death estate, but doesn't affect the residence nil rate band. Taper relief only applies to the amount of IHT due on death on a failed PET or CLT which exceeds the nil rate band available to that transfer. In this situation, the donees or trustees normally pay any IHT due in respect of the gift. The so-called 14 year rule applies if the deceased made any failed PETs or CLTs in the seven years before making a particular failed PET or CLT and reduces the nil rate band available to the later gift.

MIGHT NEED

Providers offer loan trusts and discounted gift and income trusts (DGITs) that often meet the needs of clients who want to carry out IHT planning, but are concerned about needing access to capital or income. However, a gift trust could still be the solution if someone requires access to capital because their objective is to help others in the future.

A loan trust might be suitable for someone who needs access for themselves, but can afford to give up the right to any capital growth. The outstanding loan remains in the settlor's IHT estate, while any investment growth is outside it from day one. The IHT benefits build up over the longer term, unless the settlor takes and spends loan repayments.

DGITs might be suitable for someone who requires a regular income. With the Scottish Widows version, the settlor transfers funds into a discretionary or fixed trust, carving out the right to regular capital payments for the rest of their life, funded by investment bond withdrawals. Provided the settlor is fully underwritten at the outset, the value of their carved out entitlement falls outside their IHT estate immediately. The rest of the gift falls outside their estate provided they survive for seven years.

WILL NEED

Some people have no wealth they're willing or able to give away in their lifetime, often because it's the value of the family home that's creating their IHT problem. This doesn't always mean they have no IHT planning options, although the following solutions normally involve referring clients to an adviser's legal connections.

If someone's received a legacy in the last two years, consider using a deed of variation to divert funds to a discretionary trust. The varying legatee can be a trust beneficiary without making a gift with reservation, because the deceased is treated as the settlor for IHT purposes. This gives the original legatee access to the funds without them falling into their IHT estate.

If someone's lost a spouse or civil partner and remarried, it may be possible to use a specially worded nil rate band will trust to overcome the normal 100% limit on the total transferrable nil rate band where someone has outlived more than one spouse.

Anyone considering leaving at least 4% of their net estate to charity should consider increasing the legacy to 10%. This reduces the IHT rate from 40% to 36%, which can actually increase the value of the non-charity legacies.

NOT FORGETTING CGT

Gifting assets to someone other than a spouse/ civil partner is a capital gains tax (CGT) disposal. The donor is normally liable for any CGT due because holdover relief is available only for IHT CLTs and gifts of some business assets. However, a donor making gifts in 2016/2017 benefits from the £11,100 annual exemption and CGT rates are currently low - taxable gains within the basic rate band are taxed at 10% and those above it at 20%.

Investment bonds aren't normally subject to CGT. A gift assignment of a bond to an individual or into a trust isn't a chargeable event, so the assignor has no immediate income tax liability. The chargeable event gains rules determine who the taxable person is in respect of any subsequent gains and it's often possible to use these rules to minimise any income tax liabilities.

ISAs can be another source of CGT-free funds for gifting. Many people have built up substantial funds in tax-advantaged ISA wrappers, without fully considering that these assets are in their IHT estates.

A ROLE FOR PENSIONS

Pension death benefits are normally outside someone's IHT estate, provided the scheme trustees or administrators have discretion over who the benefits are paid to and/ or the form of payment. So cohabitees can often leave pension pots IHT free to each other, unlike most assets. An additional advantage is that even substantial pension scheme death benefits won't normally count towards the £2 million limit before tapering of the new IHT residence nil rate band cuts in.

Death benefits from section 226 retirement annuity contracts and many section 32 plans fall into a deceased member's IHT estate, unless there's an individual trust. However, more recent section 32 plans (including Scottish Widows) incorporate discretionary powers over death benefit payments, with the usual IHT advantages. Section 32 providers will be able to confirm which death benefit provisions apply to particular policies.

If someone dies within two years of creating a new trust over their pension scheme death benefits, HMRC could treat the value as falling into their IHT estate. This normally only applies if the member was in ill-health and aware of this. More controversially, HMRC's Inheritance Tax Manual states it takes a similar approach if a member dies within two years of transferring pension scheme benefits.

IHT AND THE FREEDOM AND CHOICE REFORMS

The beneficiary flexi-access drawdown (FAD) options introduced by the 2015 Freedom and Choice reforms extend the IHT advantages of money purchase pensions by making multi-generation IHT planning possible. It's now worth considering whether to maximise the amount of wealth left in IHT-advantaged pensions on death. Perhaps by taking pension tax free cash, then spending or gifting primarily from ISAs falling into an IHT estate, while withdrawing just sufficient taxable pension funds to avoid a lifetime allowance charge at age 75.

As beneficiary FAD doesn't fall into anyone's IHT estate, it's now possible to pass unspent pension funds down the generations IHT free. When a member dies, providers can set up beneficiary FAD for their dependants, anyone the member nominated and for anyone at all if there aren't any dependants. The original beneficiary can nominate a successor to continue to receive beneficiary FAD after their death. The successor can nominate their own successor.

If a money purchase pension member dies under age 75, any uncrystallised funds and remaining drawdown funds within their available lifetime allowance can provide fully tax free beneficiary FAD. If uncrystallised funds exceed the member's remaining lifetime allowance, a 25% lifetime allowance charge applies to any excess used for income tax free beneficiary FAD. If the member dies age 75 or over, any funds withdrawn from beneficiary FAD are taxed at the recipient's own income tax rate. Successor FAD is income tax free or taxable depending on whether the previous beneficiary died under age 75 or aged 75 plus respectively.

Before these reforms, people commonly used bypass trusts subject to discretionary trust taxation to keep pension death benefits out of a surviving spouse's IHT estate. Bypass trusts are now more of a niche option for those who want their own choice of trustees to exert close control after their death. Where this planning is no longer required, members can amend their death benefit nominations.

PROTECTION: THE KEYSTONE

Whole of life and term policies written in trust are the keystone of IHT planning. Both types of cover can maximise the net value of any legacies to a deceased's beneficiaries. Term assurance can back up lifetime gifting by providing cover until PETs or CLTs drop out of account. Whole of life cover is often the only practical solution for cohabitees and those unable or unwilling to give away sufficient wealth during their lifetime to escape an IHT liability on death. Having cover in place might also provide funds enabling executors to pay any IHT due and obtain a grant of probate without needing to borrow against the estate.

Regular premiums on protection policies will usually be covered by the normal expenditure out of income exemption and/ or the £3,000 annual exemption. Non-exempt premiums will be CLTs where flexible/ discretionary trusts are used, or PETs if bare trusts are used.

Failed PETs or CLTs reduce the nil rate band available to the donor's death estate until the gift drops out of account after seven years. Meanwhile, unless the donor's estate falls within this reduced nil rate band, there'll be an increased IHT charge on death. Level term assurance written in trust for the estate's beneficiaries can cover this temporary IHT liability.

Lifetime gifts made within 7 years of the donor's death often fall within the nil rate band and are subject to IHT at 0%, with the IHT problem falling onto the estate as outlined above. However, if the failed PET or CLT does exceed the available nil rate band, it's normally the donees or trustees who are liable to IHT at 40% on the excess. Provided the donor survives for more than 3 years, taper relief reduces the amount of IHT due. After applying any taper relief, any lifetime IHT paid on a CLT is deducted, although no refund applies if this is more than the IHT due on death. Term assurance written in trust for the donees of a PET, or the same range of beneficiaries as the trust linked to the CLT, can provide funds to pay the IHT due. Reducing gift inter vivos term assurance, which matches the stepped IHT liability after allowing for taper relief, might be cheaper than level term assurance.

Cohabitees may well need higher levels of protection. They don't benefit from the inter-spouse exemption or the transferrable standard and residence nil rate bands. Therefore, both partners might need whole of life cover in respect of any IHT liability created for the survivor on first death. Also, the IHT bill on second death might be higher than for married couples/ civil partners with the same overall level of wealth.

While married couples and civil partners benefit from the transferrable nil rate band, if the first to die has any failed PETs or CLTs, this could use up all or part of their nil rate band. If so, this will reduce the transferrable percentage of the nil rate band available to set against the survivor's estate on second death. Depending on who made any gifts, an appropriate level of single life or joint life, second death whole of life cover could be considered, with a review planned for when the PETs/ CLTs are expected to drop out of account.

REVIEWING THE SITUATION

Many people who think they've got their IHT planning sorted out will actually benefit from a review. They may still have planning in place to use the first spouse to die's IHT nil rate band, despite the introduction of the transferrable nil rate band in 2007. Others may need a referral to specialist professional connections to keep their IHT planning on track. For example, tax tribunal decisions around trading versus investment businesses or what counts as a farmhouse can alter which assets HMRC accepts as qualifying for BPR and/or APR.

Note: Existing Techtalk articles cover many of the IHT planning ideas referred to in this article in detail. Advisers can access the archive of Techtalk articles via the Financial Planning section of the Scottish Widows website.

LASTING POWERS OF ATTORNEY: WHY IT'S KEY TO TAKE CONTROL

Jeremy Branton

A lasting power of attorney (LPA) enables clients to take control of decisions that affect them even in the event that they can't make those decisions for themselves. Without them, loved ones may be forced to endure a costly and lengthy process to obtain authority to act for an individual who has lost mental capacity. A good understanding of how LPAs operate will enable advisers to stress their importance as a key part of their clients' financial planning arrangements.

BACKGROUND

LPAs were introduced in England & Wales in 2007 as a replacement for the enduring power of attorney (EPA). An individual can create an LPA covering their property and financial affairs and/or a separate LPA for their health and welfare. It's possible to appoint the same or different attorneys in respect of each LPA and both versions contain safeguards against possible misuse. References throughout this article to 'attorney' apply equally where joint attorneys have been appointed.

Financial services have become more important as consumers are expected to take greater responsibility for their financial wellbeing. Services including payment systems are essential for full participation in society and are a key gateway to other services. (Source: FCA Occasional Paper No. 8: Consumer Vulnerability). It's not hard to imagine the difficulties that could arise where an individual loses the capacity to manage their own financial affairs and without access to their bank account, pension and investments, family and friends could face an additional burden at an already stressful time. LPAs and their equivalents in Scotland and Northern Ireland should be a consideration in all financial planning discussions and should be a key part of any protection insurance planning exercise. Planning for mental or physical incapacity should sit alongside any planning for ill health or unexpected death.

EPAs

It's no longer possible to establish a new EPA in England and Wales but those already in existence remain valid. The attorney would have been given authority to act in respect of the donor's property and financial affairs as soon as the EPA was created. At the point the attorney believes the donor is losing their mental capacity they would apply to the Office of the Public Guardian (OPG) to register the EPA to obtain continuing authority to act. Advisers are likely to encounter clients holding an unregistered EPA where the donor is either acting alone or jointly with their attorney, or a registered EPA where the attorney will be acting alone.

SCOTLAND

Similar provisions to LPAs apply in Scotland. The 'granter' (donor) gives authority to their chosen attorney in respect of their financial/property matters – 'continuing power of attorney' and /or personal welfare – 'welfare power of attorney'. The latter only takes effect upon the granter's mental incapacity.

Applications for powers of attorney must be accompanied by a certificate confirming the granter understands what they are doing, completed by a solicitor or medical practitioner only. Further information including a code of practice may be obtained from the Scottish Public Guardian's website: www.publicguardian-scotland.gov.uk

NORTHERN IRELAND

LPAs don't apply to Northern Ireland, instead those seeking to make a power of appointment over their financial affairs would complete an EPA. This would be effective as soon as it was completed and would only need to be registered in the event of the donor's loss of mental capacity with the High Court (Office of Care and Protection). Further information may be found in the following link: https://www.courtsni.gov.uk/en-GB/Services/OCP/EPA/Pages/default.aspx

The remainder of the article considers the position in England & Wales.

LPA FOR PROPERTY AND FINANCIAL AFFAIRS

It's usual for the attorney to be able to make decisions about the donor's financial affairs as soon as the LPA is registered. Alternatively the donor can state it will only apply where the donor has lost mental capacity in the opinion of a medical practitioner.

LPA FOR HEALTH AND WELFARE

Here the LPA covers decisions relating to an individual's day to day well being. The attorney may only act once the donor lacks mental capacity to make the decision in question. The types of decisions covered might include where the donor lives and decisions concerning medical treatment. The donor also has the option to provide their attorney with the authority to give or refuse consent for life sustaining treatment. Where no authority is given, treatment will be provided to the donor in their best interests.

Unlike the registration process for an EPA, registration for both types of LPA takes place up front and is not dependent on the donor's mental capacity.

PROTECTING THE INTERESTS OF THE DONOR

An attorney must act in the best interest of the donor, following any instructions and considering the donor's preferences when making decisions. They must follow the Mental Capacity Act Code of Practice which establishes five key principles:

- a person must be assumed to have capacity unless it's established he or she lacks capacity;
- a person isn't to be treated as unable to make a decision unless all practicable steps to help him or her do so have been taken without success;
- a person isn't to be treated as unable to make a decision merely because he or she makes an unwise decision;
- an act done, or decision made, under the Act for or on behalf of a person who lacks capacity must be done, or made, in his or her best interests;
- before the act is done, or the decision is made, regard must be had to whether the purpose for which it's needed can be as effectively achieved in a way that is less restrictive of the person's rights and freedom of action.

So a donor with mild dementia might be provided with the means to purchase items for daily living, but otherwise their financial matters are undertaken by their attorney. The code of practice applies a number of legally binding duties upon attorneys, including the requirement to keep the donor's money and property separate from their own or anyone else's.

WHO CAN ACT AS AN ATTORNEY?

Anyone aged 18 or over, who has mental capacity, and isn't an undischarged bankrupt may act as an attorney. A trust corporation can be an attorney for a property and financial affairs LPA. In practice attorneys will be spouses, family members or friends, or otherwise professional contacts such as solicitors. Where joint attorneys are being appointed, the donor will state whether they act:

- jointly (the attorneys must make all decisions together); or
- jointly and severally (the attorneys may make joint decisions or separately); or
- jointly for some decisions (eg the sale of the donor's property) and jointly and severally in respect of all other decisions.

An optional but useful feature of the LPA is the ability to appoint a replacement attorney in the event the original attorney is no longer able to act.

PREFERENCES AND INSTRUCTIONS

The donor can leave instructions and preferences but if they don't their attorney will be free to make any decisions they feel are correct.

Instructions relate to things the attorney should or shouldn't do when making decisions – not selling the donor's home, unless a doctor states the donor can no longer live independently or a particular dietary requirement would be examples.

Preferences relate to the donor's wishes, beliefs and values they would like their attorney to consider when acting on their behalf. Examples might be ethical investing or living within close proximity of a relative.

SAFEGUARDS

The following apply to both forms of LPA.

A 'certificate provider' must complete a section in the LPA form stating that as far as they are aware, the donor has understood the purpose and scope of the LPA. A certificate provider will be an individual aged 18 or over and either:

- someone who has known the donor personally well for at least two years; or
- someone chosen by the donor on account of their professional skills and expertise – for example a GP or solicitor.

There are restrictions on who may act as a certificate provider – these include attorneys, replacement attorneys, family members and business associates of the donor.

A further safeguard is the option for the donor to choose up to five people to be notified when an application for the LPA to be registered is being made. This allows any concerns or objections to be raised before the LPA is registered which must be done within five weeks from the date on which notice is given. The requirement to obtain a second certificate provider where the donor doesn't include anyone to be notified has now been removed as part of the Office of the Public Guardian (OPG) review of LPAs.

APPLICATION PROCESS

LPAs can be created online and once complete, the donor will need to pay the registration fee, print and sign the form, obtain the signature of the certificate provider and either the donor or their attorney will submit the LPA to the OPG to be registered.

An online service provides users with step-by-step guidance in completing each section of the LPA form.

https://www.lastingpowerofattorney.service.gov.uk/home#

The current fee to register an LPA is £110 – those receiving means-tested benefits or with a low income may pay less or no fee.

WHAT IF IT'S TOO LATE?

A person making an LPA can have help completing it, but they must have mental capacity when they fill in the forms. Otherwise, those seeking to make decisions on their behalf will need to apply to the Court of Protection for a deputyship order. This can be expensive and time consuming and may require the deputy to submit annual reports detailing the decisions they have made.

Example

Phil, a widower, had been diagnosed with vascular dementia which had been gradually developing over a number of years. His family had been aware of LPAs but had not taken the time while Phil could still manage his affairs to put them in place. Phil had always made it clear he didn't want to be placed in a residential home but as his condition worsened his family found they needed assistance from carers to help with Phil's day to day activities of living.

Although Phil was receiving both an occupational pension and state pension and held a number of savings accounts and investment holdings, none of these could be accessed once Phil finally lost mental capacity. The result was his family had to pay the care costs themselves until a deputyship order was granted by the Court of Protection. In the meantime, in addition to meeting the ongoing care costs, his family faced significant legal costs and a considerable delay in obtaining authority to manage Phil's affairs. All of which was easily avoidable had there been intervention at an earlier stage.

OTHER PRACTICALITIES

There may be other practical issues for advisers to consider.

POWERS TO MAKE GIFTS

There are strict limits on the type of gifts attorneys can make on the donor's behalf. Gifts may be made on 'customary occasions' for example birthdays, marriages and religious holidays or to any charity to which the donor was accustomed to donating. Gifts falling outside of these criteria would need to approved by the Court of Protection. An example would be a gift intended to reduce the donor's inheritance tax liability.

THE DONOR IS A TRUSTEE

Advisers may have clients who have created trusts where one of the trustees has an LPA. This can create ambiguities where the donor can still make decisions on their own affairs with the help of their attorney but wouldn't have sufficient mental capacity to continue to act as a trustee, given the overriding duty of care to beneficiaries. Early action to remove or retire a trustee while they still retain their mental capacity is recommended, otherwise it's possible to replace them under provisions of the Trustee Act 1925.

PROTECTING YOUR (IHT) PETS

Bernadette Lewis

We explain the inheritance tax (IHT) treatment of potentially exempt transfers (PETs). We also look at using life insurance to protect against failed PETs.

Making a PET can be an effective way of mitigating a potential IHT liability, if someone can give away cash or assets completely and then survive 7 years. Taper relief can reduce the IHT liability on some failed PETs, although there's often confusion about how it works. Life insurance written in trust can provide funds to pay IHT due as the result of a failed PET.

WHAT IS A PET?

A common form of PET is an outright gift of cash or assets from one individual to another. For the gift to be effective for IHT purposes, it can't be a gift with reservation. PETs also include gifts into bare trusts, where the beneficiary is absolutely entitled to the trust fund with no conditions attached. A transfer into a disabled person's trust (for IHT purposes) is also a PET.

Before 22 March 2006, transfers into a wider range of trusts were PETs. This included transfers into flexible power of appointment, interest in possession trusts and accumulation & maintenance trusts. Ongoing regular premiums to life policies already in these types of trust as at 21 March 2006 can still be PETs, as can increments to life insurance investment bonds, provided specific conditions are met.

IHT CONSEQUENCES OF MAKING A PET

For IHT purposes, a PET is treated as an exempt transfer at the time it's made and becomes fully exempt provided the donor survives the next 7 years. Unlike chargeable lifetime transfers (CLTs), there's no lifetime IHT if the PET exceeds the donor's available IHT nil rate band at the time it's made, nor are there any IHT 100 reporting requirements. If the same individual makes any subsequent CLTs, they ignore the PET when calculating their available IHT nil rate band at that time.

EXAMPLE

Richard made a gift of £450,000 into a bare trust for his child on 1 November 2006. The gift was a PET. On 4 July 2010, Richard made a CLT by transferring £200,000 into a discretionary trust. The earlier PET was ignored, so his full £325,000 IHT nil rate band was available at the time of making the CLT and there was no lifetime IHT to pay. Once Richard survived to 1 November 2013, the PET fell out of account for all IHT purposes.

If the donor dies within 7 years of making a PET, it fails and becomes a chargeable transfer for IHT purposes. If this happens, it's necessary to calculate whether any IHT is due. If the failed PET falls within the donor's available nil rate band, there's no IHT to pay on the gift. If the failed PET exceeds the donor's nil rate band, the recipient of the PET is normally liable to pay the IHT due, but HMRC can claim from the estate if it's unable to recover the tax otherwise.

A complication is that IHT transfers made up to 14 years before the donor's death can affect the calculation. The available nil rate band for any particular PET is reduced by the value of chargeable transfers (failed PETS and CLTs) made by the donor in the 7 year period before making that particular PET.

Failed PETs also use part or all of the donor's IHT nil rate band, reducing the amount available to their death estate. If non-exempt beneficiaries inherit the estate, this normally increases the IHT due. Even where the deceased donor's spouse/civil partner inherits, a failed PET permanently reduces the transferable nil rate band available on second death.

EXAMPLE

Edward made an outright gift of £100,000 to his daughter Adele on 3 June 2008. He hadn't used his £3,000 annual exemptions for the current and previous tax years. He died on 15 May 2015 leaving his £400,000 death estate to his cohabitee, Jane. As he died within 7 years of making the PET, it failed and became chargeable.

Gift to Adele	£100,000
Less 2 annual exemptions	**(£6,000)**
PET	£94,000
Covered by available nil rate band	**£94,000**
IHT due on PET	Nil

Edward hadn't made any chargeable transfers before the PET, so the £325,000 nil rate band covers the now chargeable transfer of £94,000. Although no IHT is due on this failed PET, it reduces his death estate's available nil rate band to £231,000.

Estate to Jane on death	£400,000
IHT nil rate band 2015/2016	£325,000
Failed PET to Adele	**(£94,000)**
Available nil rate band	£231,000
Taxable estate	£169,000
40% IHT due on estate	£67,600
Jane inherits	£332,400

If Edward had survived to 3 June 2015, the PET would have dropped out of account, leaving the full £325,000 nil rate band available to the estate. The estate's IHT liability would have been £400,000 – £325,000 = £75,000 x 40% = £30,000. So as result of the failed PET, the estate bears additional IHT of £37,600 (40% of £94,000).

TAPER RELIEF

Taper relief reduces the amount of IHT payable, not the value of the original gift or transfer into trust. It's only available when a failed PET or CLT isn't fully covered by the available nil rate band so that IHT is payable on death. The rate of taper relief depends on how long the donor/ settlor survived.

Period between chargeable gift and death	IHT payable
Up to 3 years	100%
More than 3 and up to 4 years	80%
More than 4 and up to 5 years	60%
More than 5 and up to 6 years	40%
More than 6 and up to 7 years	20%

EXAMPLE

Bessie died in January 2015, leaving her £200,000 estate to her husband. If he'd predeceased her, their 3 children would have inherited in equal shares. She'd used her £3,000 annual exemptions at the start of every tax year. She'd made no CLTs, but had made the following PETs to their children: £125,000 to John on 1 February 2008, £150,000 to Georgiana on 1 June 2009, £175,000 to Eliza on 1 May 2010.

All 3 PETs fail and become chargeable transfers, assessed in chronological order. John's and Georgiana's gifts fall entirely within the available nil rate band, so they have no IHT to pay. The remaining nil rate band isn't sufficient to cover Eliza's gift and she does have an IHT liability.

Gift to John	£125,000
Available nil rate band	**£325,000**
Remaining nil rate band	£200,000
	and no IHT for John to pay
Gift to Georgiana	£150,000
Available nil rate band	**£200,000**
Remaining nil rate band	£50,000
	and no IHT for Georgiana to pay
Gift to Eliza	£175,000
Available nil rate band	**(£50,000)**
Chargeable gift	£125,000
IHT @ 40%	£50,000
Taper @ 40%	**(£20,000)**
IHT payable by Eliza	£30,000

As Bessie died more than 4 but less than 5 years since she made the gift to Eliza, only 60% of the IHT is payable. This also leaves no nil rate band available to Bessie's estate. Because she makes an exempt transfer to her husband, no IHT is due. However, no transferable nil rate band remains available from her estate for her husband's executors to claim on his death.

PROTECTION SOLUTIONS

A donor can write a life policy in trust to provide funds to meet the potential IHT if a PET fails. Using a trust keeps the proceeds outside the donor's estate and readily accessible to pay any IHT on death. Depending on who might be financially disadvantaged, discretionary/ flexible or bare trusts could be suitable. Regular premiums are normally exempt, provided the donor pays them out of their normal income without affecting their standard of living. If this isn't possible, the premiums might fall within the £3,000 annual exemption. If the premiums are non-exempt, they're CLTs when paid on policies in discretionary/ flexible trusts and PETs when paid on policies in bare trusts.

When considering appropriate sums assured, the IHT nil rate band is frozen at £325,000 until April 2021. A transferable main residence nil rate band is being phased in from April 2017, worth up to £100,000 in 2017/2018, £125,000 in 2018/2019, £150,000 in 2019/2020 and £175,000 in 2020/2021, and then indexed in line with CPI. However, it will be reduced by £1 for every excess £2 where an estate is over £2 million. It will normally be available only where a main residence is left directly to children or other lineal descendants, although protections apply to those who downsize or cease to own a home after 7 July 2015.

EXAMPLE

Maria, a widow, makes an outright gift of £200,000 to her granddaughter Helen. Maria's £3,000 annual exemptions for the current and previous tax years are available. Maria's will leaves her substantial estate to those of her children who survive her, with any deceased child's share taken by their children, if any.

The PET to Helen falls out of account for IHT purposes if Maria survives 7 years. Until then, a failed PET of £194,000 won't lead to any IHT liability for Helen. However, it would reduce the nil rate band available to Maria's estate. The potential IHT liability is £194,000 x 40% = £77,600.

The solution could be a 7 year own-life level term assurance (LTA) on Maria's life for £77,600, written in a discretionary trust with potential beneficiaries including her children and grandchildren. If Maria can cover the premiums out of her normal income, they should be exempt transfers for IHT. If Maria dies within 7 years, the trustees can use their discretion to ensure the policy proceeds benefit whoever inherits her estate, in compensation for the reduction in their inheritance caused by the IHT.

A gift inter vivos (GIV) policy is a decreasing term assurance (DTA) covering the IHT liability on a failed PET that exceeds the nil rate band. GIV cover sometimes uses 5 level term policies each for 20% of the overall sum assured, but with different terms, so the total cover matches the reducing liability (see following example). Where GIV cover is used, there's still the need to consider the potential IHT liability on the estate itself.

When considering protection to cover the potential IHT liability if a PET fails, don't forget the impact of a failed PET on the transferable nil rate band. In this case, a joint life, second death, whole of life policy written in trust might be the solution.

EXAMPLE

St John makes a PET of £744,000 to his daughter, Bertha. His will leaves his estate to a discretionary trust, with a private letter of wishes setting out his intended beneficiaries. After making the PET, his estate is valued at £1 million.

If St John dies within 7 years and the PET fails, there'll be no IHT nil rate band available to his death estate, creating an additional £325,000 x 40% = £130,000 IHT liability, assuming no increase in the nil rate band as at the date of his death.

Bertha is liable to any IHT on the PET, benefitting from taper relief if St John survives for at least 3 years. Bertha's potential IHT liability is:

If St John dies up to 3 years after making the PET: £744,000 x 40% = £297,600

More than 3 and up to 4 years: £297,600 x 80% = £238,080

More than 4 and up to 5 years: £297,600 x 60% = £178,560

More than 5 and up to 6 years: £297,600 x 40% = £119,040

More than 6 and up to 7 years: £297,600 x 20% = £59,520

The solution could be to set up a 7 year GIV policy on St John's life, with an initial sum assured £297,600 reducing in 20% steps after 3 years to £59,520. It could be written in an absolute trust for Bertha's benefit or a discretionary trust. Unless existing cover is in place, this solution would also require a 7 year LTA for £130,000 on St John's life, written in discretionary trust, so the trustees can use the proceeds for the intended beneficiaries of his estate. Depending on the comparative costs, another solution could be a 7 year LTA for £427,600 in a discretionary trust, to cover the liabilities on both the PET and the estate.

Years after making PET	Up to 3	3–4	4–5	5–6	6–7
GIV 3 year term	£59,520				
GIV 4 year term	£59,520	£59,520			
GIV 5 year term	£59,520	£59,520	£59,520		
GIV 6 year term	£59,520	£59,520	£59,520	£59,520	
GIV 7 year term	£59,520	£59,520	£59,520	£59,520	£59,520
GIV DTA total	£297,600	£238,080	£178,560	£119,040	£59,520
7 year LTA	£130,000	£130,000	£130,000	£130,000	£130,000
Total cover	**£427,600**	**£368,080**	**£308,560**	**£249,040**	**£189,520**

As St John's estate is valued at £1 million after making the PET and will go to a non-exempt discretionary trust, there will be a significant IHT liability whenever he dies. He should also consider a whole of life policy with an initial sum assured of £270,000 (£1,000,000 - £325,000 x 40%), written in discretionary trust. Even if he has appropriate cover in place already, he should arrange regular reviews.

When considering protection to cover the potential IHT liability if a PET fails, don't forget the impact of a failed PET on the transferable nil rate band. In this case, a joint life, second death, whole of life policy written in trust might be the solution.

EXAMPLE

Fairfax is married to Blanche. They're childless and their wills leave their estates to each other on first death and then to Fairfax's nephew Oliver. Fairfax makes a PET of £97,500 to Oliver. After making the PET, the value of the survivor's estate on second death will be £600,000.

If Fairfax dies within 7 years and Blanche has already died, the £97,500 failed PET will be within his available nil rate band. If the nil rate band is £325,000, the amount available to his estate will reduce to £227,500. Assuming a 100% transferrable nil rate band from Blanche's estate, the overall nil rate band available to his estate is £227,500 + £325,000 = £552,500. If the estate is still valued at £600,000, the IHT liability is £47,500 x 40% = £19,000.

If Fairfax dies within 7 years and Blanche survives him, the failed PET will use 30% of his nil rate band if it's still £325,000. Let's assume Blanche lives on for some years and the nil rate band is £350,000 when she dies with an estate of £650,000. Her estate benefits from an overall nil rate band of £350,000 plus (70% x £350,000) = £595,000. So there's an IHT liability of £55,000 x 40% = £22,000.

If Fairfax survives 7 years, the PET drops out of account. There's no IHT to pay on first death as the survivor is an exempt beneficiary. The estate of the second to die goes to Oliver, and benefits from 2 full nil rate bands. At present, this would be 2 x £325,000, so there should be no IHT on a £600,000 estate.

A joint life, second death, whole of life policy written in either a discretionary trust or a bare trust for Oliver might be an appropriate solution. If Fairfax dies within 7 years, predeceased by Blanche, the policy will pay out on his death and provide funds towards his estate's IHT liability resulting from the failed PET. If Fairfax dies within 7 years, survived by Blanche, the policy will pay out on her death whenever this occurs and provide funds towards her estate's IHT liability caused by the reduction in the transferrable nil rate band. She will need to review the cover from time to time. If Fairfax survives for 7 years, they can cancel the policy, unless changed circumstances mean it's still required.

This publication represents Scottish Widows' interpretation of the law and HMRC practice at the time of writing this publication.
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