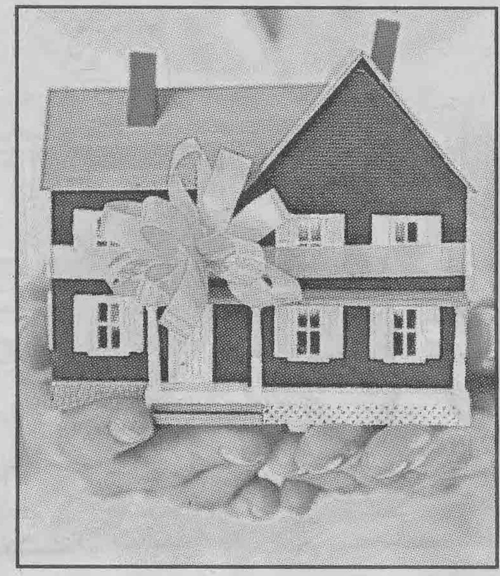
Avoid a tax raid on your inheritance

By Laura Shannon



Picture: ALAMY

LITTLE-KNOWN tax tricks could help thousands of families avoid a raid on their inheritance by HM Revenue & Customs, or at least cap the impact.

Inheritance tax (IHT) receipts increased to more than £2.7billion in the year to April 2011 — an annual rise of 14pc.

Sizeable estates will inevitably invite a tax bill, but middle-class families can eliminate or limit IHT with some preparation and professional advice.

Tax laws also allow wealth to be portioned, or drip-fed, to families each year, so make full use of the benefits.

WHAT ARE THE RULES?

IF YOUR estate — which includes everything from property and possessions to shares and savings — is below £325,000 for an individual (or £650,000 for a couple), there is no inheritance tax to pay.

But anything your beneficiaries inherit above this exemption will be subject to a 40pc charge. This can be quite onerous. For example, an estate worth £800,000 would see a tax bill of £60,000.

However, if you live for seven years after giving away money or assets, or give them to a spouse or civil partner, these gifts will avoid inheritance tax.

SPEND MORE

PEOPLE are living longer, so it makes sense to use some of the funds instead of giving it all away, according to John Whiting, of the Chartered Institute of Taxation.

'A good tip is to spend some of it,' he says. 'But don't leave yourself destitute.'

Unlimited regular payments can be made from after-tax income, but you must maintain your normal lifestyle. This income could include part-time work, a pension, or interest from savings. However, you cannot make exempt regular payments if you make them from your capital.

You can also give as much as £3,000 as a lump sum every year tax-free. So if you give away only £2,000, then you can hand over the unused £1,000 allowance in the following year (so a total of £4,000). But you can do this only once in consecutive years.

Small sums up to £250 can be made to any number of people within one tax year.

GET MARRIED

IT'S not very romantic, but tax is a compelling reason for marriage.

'Transfers to a spouse or civil partner fall outside of the inheritance tax net,' says Mr Whiting. If you leave assets to your spouse or civil partner, this means they can bequeath up to £650,000 (their allowance of £325,000, plus yours) free of inheritance tax.

You can give tax-free gifts to a couple getting married: up to £5,000 from parents and £2,500 from grandparents.

However, technically, this has to be at least promised before the ceremony, even if the payment is made many months later.

GIVE BIGGER GIFTS

HIGH value transfers of money, investments or even antiques bequeathed before you die are known as 'potentially exempt transfers'.

They are exempt from IHT only if you live for seven years. But if you die within this period, these gifts will be taxed at their current value, not their value when you gave them away.

USE YOUR HOME

IN THEORY, you can give away property and dodge inheritance tax if you meet the seven-year rule.

But if you stay living there rent-free, the gift is classed as a 'gift with reservation of benefit' and is subject to IHT.

Seek legal advice when gifting property because it can be a costly mistake. For example, if given to a relative as their second home, the property may be liable for capital gains tax when sold in the future.

This will be based on the difference between the price at the date the ownership was transferred and the value when it was sold.

Equity release — where home-owners withdraw some of the capital in their property in the form of a home loan — can help to reduce the tax liability on property. The debt, or the share of the property given up, will be deducted from the final value of the estate.

WHAT ABOUT PENSIONS?

CASH gifts can result in a 'double whammy' of tax benefits if the recipient uses it as a pension contribution. This is because pension contributions incur tax relief at the saver's highest rate of income tax.

So if you paid £10,000 into your child's pension, this would effectively be worth £16,666 if they were a higher-rate 40pc tax payer.

And the gift itself is free of inheritance tax if the benefactor survives for another seven years.

Jason Witcombe, independent adviser at Evolve Financial Planning, says: 'Cash gifts can be used to mop up pension tax relief, part at source and part via a tax return. It's inter-generational planning.'