HSBC Private Banking

Podcast transcript

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Estate planning in an uncertain world

Strategies for lifetime inheritance tax planning

Jeremy Franks: Welcome to the HSBC Private Banking second podcast in our series on estate planning in an uncertain world. Today, we'll focus on lifetime inheritance tax planning. We are recording this podcast from our homes, so apologies in advance for any background noise. My name is Jeremy Franks. I'm the Head of Wealth Planning for Europe, Middle East, and Africa, and I'm joined by my colleague Patrick Power, who leads our financial planning proposition in the UK. Welcome, Patrick.

Patrick Power: Thanks, Jeremy, good to be here.

Jeremy: Great to have you, Patrick. Let's dive straight in around lifetime inheritance tax planning. What's the most effective strategy for lifetime inheritance tax planning?

Patrick: Okay, so the most effective is gifting. Gifting and surviving. There are actually four strategies. We will go through them, but we'll start with gifting because it's by far the most popular and most effective. You can gift either outright or via trust, but we're going to pick up on the use of trust in the next podcast. Here, we're going to just focus on those strategies.

Jeremy: Okay, so how much can you gift outright?

Patrick: So, the simple answer is you can gift as much as you like outright. If it's an outright gift, then you have no reservation of benefits. You're just giving the assets away completely. You're exerting no control. That's known as a potentially exempt transfer. You need to survive seven years from the date of the gift, and then it drops out of the estate.

Jeremy: And what happens if you die within seven years, Patrick?

Patrick: So yes, if you die within seven years, then the gifts... And they're taken in chronological order, so the earliest gift is covered by your nil-rate band. If that gift or subsequent gifts exceed the nil-rate band, then the excess is taxed. However, after three years, the rate of tax is relieved, it’s this thing called taper relief. So, for the first three years it's at the full rate. If it's not covered by the nil-rate band, is it the full rate of 40%. And then it reduces to zero over years four, five, six, and seven.

Jeremy: So, it reduces by 8% per annum. So, if you die between year three and four, it's 32%, four and five 24%, and so on.

Patrick: Yeah, and technically the donee, the recipient of the gift, has to pay that tax.

Jeremy: Okay. And also another valuable advantage to a potentially exempt transfer is if you gift an asset that's going to appreciate in value, should you die at any point before the seven years, the value which is taken is generally the value at transfer rather than the value at death. So, if the asset appreciates significantly, the lower value is taken.

Patrick: That's correct. It's the value of the date of gift. So, any future growth is exempt, it’s outside of your estate anyway. If the value has gone down since the date of the gift, there is some relief available.

Jeremy: And what types of assets can be given away?

Patrick: So technically, anything can be given away. But the caveat there is that if the asset you're giving away is standing at a gain, and the recipient of the gift isn't a spouse or civil partner, or an exempt beneficiary, then that's a trigger for capital gains tax because it's a transfer of wealth. So, the most popular asset to giveaway is cash because there's no capital gains tax on cash. And also, given the current states of markets, given the COVID-19 crisis, where we've seen asset prices fall, there's perhaps an opportunity to re-evaluate assets in your estate. And if they're standing at a loss or the gain is much reduced, there may be an opportunity to consider actually gifting those now if and you can afford to do so.

Jeremy: You make a very important point there. Always consider the capital gains tax implications as well as the inheritance tax implications of any transfers. Just turning to a very valuable exemption but from my experience is often overlooked. Normal expenditure out of income – do you want to elaborate a little bit about that?

Patrick: Yeah, absolutely. This is not widely known. It's been around for a while. But not everyone can benefit from it. But if you can, it's an extremely valuable strategy to use. So, if you can demonstrate that you have surplus income, that's income above and beyond that amount required to maintain your lifestyle, then you can give it away. As long as the gift is of a regular nature, then you can give that away, and it's immediately outside the estate. There's no requirement to survive that seven years. So, if you can form a regular pattern of surplus income gifting, then that's going to be a really inheritance tax efficient way of getting assets out of the estate.

Jeremy: Okay. And so, you could use normal expenditure out of income to gift either to an individual or to a trust.

Patrick: Absolutely. A key thing with surplus income gifting is it's up to the executor of your will to actually prove to the revenue that gift was made from surplus income. So, keeping meticulous records is very, very important.

Jeremy: Okay. So, turning to the next strategy of asset freezing, this is very much around effectively stripping out any future growth in value from your estate. Practically, how can you implement such a strategy?

Patrick: Yeah, you're right. It's about freezing the value of that asset at the current value, and all the future growth is outside the estate. So, what you do is you set up a structure, and that could be a corporate structure, or it could be a trust. So, let's use the trust example. You'd lend the trust a sum of money. That money is now owed to you. So that's an asset of your estate. However, the trust itself, invests the funds, and they belong to the beneficial owners of the trust. So that would be generation two, generation three. So, all that growth is going to the next two generations. The original value of the asset stays in your estate, but it's frozen. It won't increase in value.

Jeremy: Okay. So, in the long term it can be a particularly effective strategy particularly, I would assume, for assets which are likely to appreciate significantly in value. I think also another potential benefit is if an individual isn't sure how much they're going to need for the rest of their life. This gives them, let's say, flexibility. They can keep the asset at the current value, effectively, but try and strip out any future growth in value. So at least they've got comfort and confidence in respect of having sufficient resources for the rest of their life.

Patrick: You're absolutely right. They can access the original capital, if you like, that's owed to them. It's obviously a long-term, effective strategy. It's going to take time for that growth to accumulate. But if you had those assets in your estate and you fast forward 20, 30 years, think how much your estate could have increased in value just by holding those assets inside the estate. So, giving away that growth is extremely useful strategy, but it takes a while to be effective.

Jeremy: Turning to the next strategy and insurance. This isn't really an inheritance tax mitigation strategy. This is more perhaps giving yourself flexibility and ensuring that there are sufficient funds available

to pay a future inheritance tax liability, perhaps on assets you retain within your own personal balance sheet, for want of a better description.

Patrick: Yeah, that's right. If you identify that you have surplus wealth that's what you're going to attack with seven-year gifting, maybe doing a bit of asset freezing as well. But there'll be certain parts of your estate that most unlikely will ever be gifted, and you'll retain access to those. They'll stay in your estate. So that's where you'd look at insurance as taking out the level of cover equal to the inheritance tax liability. Typically, if you have a tax-efficient will, you'd have the inheritance tax triggers, is probably going to be at the second death. So, the second to die of a married couple or civil partners, that's the point that inheritance tax would kick in. So that's when the life cover would need to pay out. So whole of life policies will pay out, so they're more expensive than say term cover policies. However, if you look at the premium cost, and over time you divide that into the value of the estate, then you could argue that that's your effective inheritance tax rates if you like, because you've hedged out that liability using a whole of life policy. Equally, if you're engaging in seven-year gifting programmes for your surplus wealth and you're attacking that, the seven-year contingent liability, where inheritance taxes is to be charged if you die within seven years of making those gifts. That's ideal for life cover because life insurance over seven years, the cost is relatively low. Seven years is a relatively short period of time, so term cover would be ideal. And you can get policies that would match the reducing tax liability that we talked about with that taper relief. So ,insurance can be a really, really sensible strategy just to tidy everything up and cover those liabilities.

Jeremy: And I think you make a very good point. Inheritance tax is often around combining strategies, and I think the insurance option combined with, as you say, potentially exempt transfers can be very effective in the right set of circumstances. Turning to the last strategy of using exempt assets, now this is very much around utilising exemptions for exists. What I'm specifically referring to here is, for example, many entrepreneurs I've dealt with over the years have unquoted trading companies by virtue of the nature of their roles and responsibilities. They often don't realise that those unquoted trading company shares may be exempt from inheritance tax.

Patrick: Absolutely. So they look at their balance sheets and they can identify those assets that are exempt from inheritance tax or have this 50% or 100% relief from inheritance tax, then there's some great planning that they could do with those assets, provided they obviously can afford to give them away. So, it opens up a whole bunch of opportunities with not only outright gifts but using trusts. In the next podcast, we'll explain some of the cost issues with trusts and the lifetime transfer charge that you have with regards to transfers of assets or most assets into trusts. However, if those assets have this relief, then that's not an issue, and you're unlimited in the amount you can actually place into trust. I would add a note of caution, there are some schemes that are marketed out there which will aim to get individuals to take their funds and move them into these assets. And clients may not have much experience in those areas, say farming or in certain business activities. So, to get the relief, the government gives that really because you're taking a very high commercial risk. So, a word of warning that you could actually end up in investing in these schemes, getting the relief after a couple of years, which is the qualifying period. But taking such a commercial risk, that actually, you could see the assets fall dramatically. So, inheritance tax efficient for the wrong reasons, you could argue.

Jeremy: I would completely agree with you. I'd never, never suggest letting the tax tail wag the investment dog. Just to bring this conversation to a close, and just to summarise very briefly, there are numerous strategies for looking at lifetime inheritance tax planning. But in short, they are gifting, freezing, using insurance, and taking advantage of exemptions, particularly around business property relief or agricultural property relief if you have assets that may qualify.

Jeremy: I think that flexibility and lifetime planning is a really important point to consider at the moment. Clearly, the crisis has impacted valuations and that may facilitate even more effective and efficient planning at this moment in time. Another relevant point, which I'll ask Patrick for his final words on, is there has been much speculation and commentary on reports by the Office of Tax Simplification and an all-party, cross-party parliamentary committee on intergenerational estate planning. Would it be fair to say, Patrick, that some of the exemptions and reliefs that we've discussed today, it's quite possible may not be around for too much longer?

Patrick: Well, given the unprecedented levels of government borrowing, the risks are there that they're going to take a look at increasing the taxes across the board. And inheritance tax is perhaps one where a lot of groundwork has already been done. Like you mentioned, the Office of Tax Simplification have submitted two papers with recommendations to the reform of the inheritance tax regime. The cross-party parliamentary group paper, it shows there's consensus in parliament because really, some quite radical proposals that were in that paper... I stress, this is not government policy, currently, but it can influence government policy. So, if there is a change to the current rules, I'd say that now's the time to really take a deep look at that and see what options you've got in the current regime because that could change.

Jeremy: Absolutely. And I think some of the exemptions and reliefs and strategies that we've talked about today could look very generous in a new regime.

Patrick: Absolutely.

Jeremy: On that note, all that remains is for me to thank Patrick for his insights today and strongly encourage listeners if they are keen to explore any of the issues raised today, please do discuss these with your Relationship Manager and they can arrange meetings with our Wealth Planners who are well positioned to work with you and your lawyers and your tax advisors to take forward these opportunities. Thank you very much for listening. Keep well.