Financial Planning infobyte 2013

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Loan bombshell for IHT

The Chancellor's 2013 Budget contained a wholly unexpected change to the treatment of loans for inheritance tax. Until now, the taxable value of an estate would be reduced by the amount of any loan outstanding on death, but in future the borrowing will have to be matched against the asset which has been acquired with the loan.

This will substantially reduce the advantages of equity release schemes for those whose estates exceed the £325,000 nil rate band in value.

It will also affect schemes which are designed to take advantage of Business Property Relief and Agricultural Property Relief. Many of these schemes have involved the financing of assets which will qualify for relief by means of loans on assets which are liable for inheritance tax. An example might be that of a bank making a loan to someone wishing to buy a business asset and securing this by means of a legal charge on their home.

The consequence, presumably unintended, is that a measure designed to curb tax planning will hit the business owners the Government says it wishes to support.

More Budget restrictions

Many taxpayers take out life insurance on their own lives to provide a lump sum with which their beneficiaries can pay the inheritance tax on their estates. However, the proceeds only escape being taxed if the policies are held on trust, and so avoid being included in the estate.

However, with the objective of limiting tax breaks for better-off taxpayers, the Government has introduced a cap of £3,600 on the total annual premiums which can be paid for such policies

Acceptable tax mitigation

In an effort to crack down on tax avoidance, the Government has given HM Revenue & Customs what many advisers regard as worryingly vague powers to penalise what it regards as unacceptable tax mitigation schemes.

It had been thought that an arrangement to which exception would not be taken is that involving so-called "pilot trusts". These provide a means of extending the "nil rate band", which exempts from inheritance tax the first £325,000 of a deceased's estate.

Under a pilot trust arrangement, a series of trusts would be set up on successive days, perhaps for a testator's grandchildren, and a nominal sum of perhaps £100 would be invested in each trust. The testator's Will would then direct that a much larger sum, of perhaps £250,000, should be paid from the estate into each trust from the estate.

The effect is that each trust would acquire a separate nil-rate band, so if there were four trusts, a total of £1.3 million would be exempted from inheritance tax.

However, it may be too soon to relax. On 31 May 2013 HMRC issued a consultation paper proposing that all trusts set up in lifetime or death by the same settlor should be treated as related trusts. This would catch pilot trusts, with retrospective effect.

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How to spend a pension pot

It should not be assumed that a pension pot can only be applied to providing a retirement income. The options now available enable retirees to plan the best use of this resource having regard to their own needs and those of their dependants and the desirability of minimising both income tax and inheritance tax.

If maximising income were the objective, a fund of £500,000 could at current rates secure an income of around £26,000 p.a., based on a single life, or £23,000 for a husband and wife. However, most people would consider it prudent to provide for inflation, and if an inflation-linked annuity were selected the initial income would reduce to around £12,000.

Many would regard this return as unattractive and might consider delaying annuitising in the hope that rates might improve, and meanwhile drawing an income from their pension fund by switching into “capped drawdown”. There is a limit to the level of income which can then be drawn from the fund, but the maximum level would currently exceed the single life fixed annuity rate and provide some £28,000 p.a.. However, drawing the maximum income might erode the capital value of the fund, and it would be prudent to take a lower level of drawings.

The “cap” on drawings does not apply if the pension holder opts for “flexible drawdown”, but this option is only available if the retiree has secured a guaranteed pension of at least £20,000 p.a., for example by means of State pension or scheme pension or pension annuity.

If the retiree has an eye not solely on income, but also on the preservation of value for the benefit of dependants, “phased drawdown” might be considered. This involves progressively encashing the segments into which pension funds can be divided and drawing 25% of each segment in the form of tax-free cash to supplement the income. The uncashed portion of the fund would remain invested in the tax-favoured environment of the pension fund.

If the objective were to preserve the value of a pension fund for the benefit of dependants, this would best be achieved by delaying drawing either tax-free cash or income from the fund until after age 75. If the pension holder were to die before this age, the entire fund would pass to their beneficiaries completely free of inheritance tax, whereas on death after the age of 75, a tax charge of 55% would be levied on the fund, if this were taken as a lump sum.

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