FINANCIAL FOCUS
PAVEY GROUP FINANCIAL SERVICES NEWSLETTER
SUMMER ISSUE 2019 ■ ISSUE 14

PAVEY group FINANCIAL SERVICES

Inheritance Tax

No longer something that only affects the very wealthy

Inheritance Tax is no longer something that only affects the very wealthy, but the good news is that there are ways to limit the amount of Inheritance Tax your family may potentially face.

When someone dies, Inheritance Tax is charged on their estate above a certain value. A person's estate is basically everything they own, including their main property, any other properties, cars, boats, life assurance policies not written in an appropriate trust and other investments, as well as personal effects such as jewellery.

Inheritance Tax is potentially charged at a rate of 40% on the value of everything you own above the Nil-Rate Band threshold. This is the value of your estate that is not chargeable to Inheritance Tax. The amount is set by the Government and is currently £325,000, which is frozen until 2021. When you die, your estate is not liable to tax on any assets up to this amount. However, anything over this amount may be taxed at a rate of 40%.

Since 6 April 2017, if you leave your home to direct lineal descendants, which includes your children (adopted, fostered and stepchildren) and grandchildren, the value of your estate before tax is paid will increase with the addition of the Residence Nil-Rate Band, currently £150,000 in 2019/20.

Inheritance Tax is an unpopular and controversial tax, coming as it does at a time of loss and mourning, and it can impact on families with even quite modest assets. However, there are legitimate ways to mitigate against this tax. But be aware that some of the most valuable exemptions must be used seven years before your death to be fully effective, so it makes sense to obtain professional financial advice and consider ways to tackle this issue sooner rather than later.

Making plans to mitigate against Inheritance Tax

Make a Will

Dying intestate (without a Will) means that you may not be making the most of the Inheritance Tax exemption which exists if you wish your estate to pass to your spouse or registered civil partner. For example, if you don't make a Will, then relatives other than your spouse or registered civil partner may be entitled to a share of your estate, and this might trigger an Inheritance Tax liability.

The facts:

- Inheritance Tax is levied at a fixed rate of 40% on all assets worth more than £325,000 per person (0% under this amount) – or £650,000 per couple if other exemptions cannot be applied
- The Residence Nil-Rate Band is currently £150,000. This is an allowance that can be added to the basic tax-free £325,000 to allow people to leave property to direct descendants such as children and grandchildren – the allowance will be reduced by £1 for every £2 that the value of the estate exceeds £2 million

Make lifetime gifts

Gifts made more than seven years before the donor dies, to an individual or to a bare trust, are free of Inheritance Tax. So, if appropriate, you could pass on some of your wealth while you are still alive. This will reduce the value of your estate when it is assessed for Inheritance Tax purposes, and there is no limit on the sums you can pass on.

You can gift as much as you wish, and this is known as a 'Potentially Exempt Transfer' (PET). However, you will need to live for seven years after making such a gift for it to be exempt from Inheritance Tax. Should you be unfortunate enough to die within seven years, then it will still be counted as part of your estate if it is above the annual gift allowance.

You need to be particularly careful if you are giving away your home to your children with conditions attached to it, or if you give it away but continue to benefit from it. This is known as a 'Gift with Reservation of Benefit'.

Leave a proportion to charity

Being generous to your favourite charity can reduce your Inheritance Tax bill. If you leave at least 10% of your estate to a charity or number of charities, then your Inheritance Tax liability on the taxable portion of the estate is reduced to 36% rather than 40%.

Set up a trust

Family trusts can be useful as a way of reducing Inheritance Tax, making provision for your children and spouse, and potentially protecting family businesses. Trusts enable the donor to control who benefits (the beneficiaries) and under what circumstances, sometimes long after the donor's death.

Compare this with making a direct gift (for example, to a child), which offers no control to the donor once given. When you set up a trust, it is a legal arrangement, and you will need to appoint 'trustees' who are responsible for holding and managing the assets. Trustees have a responsibility to manage the trust on behalf of and in the best interest of the beneficiaries, in accordance with the trust terms. The terms will be set out in a legal document called 'the trust deed'. ■

WILL YOUR LOVED ONES BE FACED WITH A LARGE TAX BILL?

Without making provision for Inheritance Tax, your loved ones could be faced with a large tax bill when you die. They may even have to sell assets, such as the family home, in order to pay the bill. With some forward planning, we can help ensure that the people you want to benefit from your estate actually do. To assess whether you need to consider making plans to mitigate a possible Inheritance Tax liability, please contact us.

INFORMATION IS BASED ON OUR CURRENT UNDERSTANDING OF TAXATION LEGISLATION AND REGULATIONS.

ANY LEVELS AND BASES OF, AND RELIEFS FROM, TAXATION ARE SUBJECT TO CHANGE.

THE RULES AROUND TRUSTS ARE COMPLICATED, SO YOU SHOULD ALWAYS OBTAIN PROFESSIONAL ADVICE.

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Protecting the value of your money

Don't ignore the corrosive impact rising prices can have on your investments

Inflation is an economy-wide sustained trend of increasing prices from one year to the next. The rate of inflation is important as it represents the rate at which the real value of savings and an investment is eroded and the loss in spending power over time. Inflation also tells investors exactly how much of a return their investments need to make for them to maintain their standard of living.

To avoid losing value, your savings and investments need to grow at the same rate as prices are rising. In the current climate of lower interest rates, however, achieving this could be a challenge. During periods of rising inflation, those who save into deposit accounts may look to redirect their savings into investments in a bid to achieve potentially better returns, but it's important to appreciate the risks. Unlike cash bank accounts, investments can fall as well as rise, and you could get back less than you invest, or lower returns than you might otherwise have achieved.

Interest rates on deposits in Cash Individual Savings Accounts (ISAs) have generally remained below inflation over the past few years. Some savings accounts offer higher rates, but most pay interest below the current rate of UK inflation – even if you tie your money up for three years.

Investing in bonds

If you are prepared to take on some investment risk, you could consider investing in a bond fund. Bond funds invest in a basket of IOUs issued by governments and/or companies looking to raise cash. When someone invests in a bond, they are essentially lending the bond issuer their money for a fixed period of time. During the bond's life, they will receive a fixed rate of interest, known as the 'coupon', and when it matures, those who invested when the bond was first issued should get their original capital back.

However, it's important to understand that your investment is not guaranteed. If the issuer gets into financial trouble, it could fail to meet its interest payments or even repay your capital. If that happens, you could get back less than you invest or nothing at all.

While you can invest in an individual bond at launch, they are also bought and sold on the open market, so you can invest at any stage in a bond's life. But remember, if you buy a bond after it has been first issued, you will pay its market price, which could be higher or lower than its issue price.

On the secondary market, bond prices change regularly, and as a result the yield on offer will also alter, so the rate of interest you receive will be dependent on its price at any given time. In addition, when it matures, the capital repayment will be the amount which was paid when it was initially issued and again – this could be higher or lower than what you paid. If you sell, you will get the market price, and that may be less than you paid.

Broadly speaking, bonds are typically viewed as a lower-risk than shares and generally offer a relatively steady and predictable income, though some bonds do carry higher risk than some shares.

Opting for a bond fund can help you diversify your risk, but these portfolios come in many guises, and as such some will carry greater investment risk than others. Generally, they will all hold bonds that are at various stages of their life and therefore will vary in value.

Investing in shares

An inflationary backdrop may be less harmful for equity investors because during such periods, companies will often increase their product prices when the underlying costs start to rise. As a result, company earnings may have the potential to keep up with inflation, but there can be no guarantee of this, and some companies may fail in inflationary times. If you are considering investing in the stock market, remember that the value of the shares that you buy can fall as well as rise, and you could get back less than you invest.

But opting for a fund which invests in a wide spread of stocks is going to be less risky than putting your money into just a handful of shares. While you could invest in a low-cost tracker fund, which will simply mirror the performance of a particular index, such as the UK's FTSE 100, equity income portfolios also aim to deliver a steady income stream as well as capital growth.

These vehicles invest in the shares of dividend paying firms, or companies that tend to share their profits with their shareholders, and investors can opt to either take the income or instead re-invest it. It is vital to understand that dividends are not guaranteed: they depend on the companies' profits and those companies can decide to cut or cancel their payouts altogether, all of which can also cause share prices to fall.

Investing in property

Property in general is another asset class known for typically staying ahead of the cost of living over the long term. But while buying a property outright is quite an elaborate step to take to beat inflation, you can still access the asset class by going for a fund, which invests directly in bricks and mortar.

By doing so, it helps you to not only diversify your portfolio away from just bonds and shares but also spread your money across a broad range of properties, such as office buildings as well as industrial and retail parks. This can help with diversification by ensuring that if one or more buildings are unoccupied for a period of time, the other properties can still generate income.

The rents paid by tenants, which are often linked to inflation, can provide a stable and sometimes rising income, while over time property values could potentially appreciate. However, commercial property prices can be volatile, and when the economic backdrop becomes uncertain, many buildings may fail to attract a sufficient number of tenants, or tenants could become solvent and default on rents, which means values and investment returns are very likely to fall.

In addition, it is vital to remember that property is an illiquid asset – in other words, it cannot be sold quickly. This means that if values start to fall and investors en masse try to get their money out, fund management groups can impose so-called 'lock-in' periods, which means you will have to wait until the firm sells some of its assets before you can get your money back. ■

TIME TO REVIEW YOUR CURRENT PORTFOLIO?

Inflation can have a corrosive effect on the money that you've set aside for your future. Rather than rising in value, as you might hope, your savings could be being slowly diminished. If you would like to review your current portfolio, please speak to us – we look forward to hearing from you.

To arrange a complimentary consultation or review, please contact our Independent Financial Advisers on 01803 652030.