Duty calls

Inheritance tax can swallow up as much as 50 to 60 per cent of your estate when you die. Different countries have different rules, but there are several ways in which you can hold on to as much as possible, explains **James Leavey**.

Preserving wealth from one generation to another may not be as hard as creating it, but it is much more difficult than most families believe. A recent study by investment bank JP Morgan, based on analysis of 21 years of *Forbes* magazine's rich list, found that only one in five has been able to maintain a position among the top 400 over two decades. A mere 54 of the original 400 names now remain on the list. For an overwhelming number – 205 – wealth did not grow or actually declined. 37 had their wealth 'realigned' to a wider range of owners – family members, charitable trusts and private foundations – and another 14 were removed from the list after additional research. Of the original *Forbes* 400, 90 have died, their wealth distributed to family members, foundations and, through taxes, the US Treasury.

Yes, of course you cannot take your wealth with you, but if you want to guarantee your family's future legacy, it is inheritance or estate tax that you and your financial advisers should be looking at most carefully. No one, no matter how powerful, is exempt. When Charles Woolworth died in 1947 leading a gross estate of $17m, $10m was deducted in estate taxes. When Conrad Hilton died in 1979 leaving $199m, the US Government helped itself to $105m. In 1983, Jessica Savitch's $2m legacy was made even paltrier when 50 per cent of it was swallowed up by estate tax.

Part of the blame belongs to the Emperor Augustus, who was probably the most brilliant tax strategist of the Roman Empire, and instituted an inheritance tax to provide retirement funds for the military: 5 per cent on all inheritances, except gifts to children and spouses. Centuries later, the English and Dutch followed Augustus's lead when developing their own inheritance tax regimes.

Generally speaking, fiscal authorities around the world, driven by a growing need to raise revenues, are increasing their ability to tax wealth and have become increasingly adept at tightening the rules. 'As a result, some long-familiar strategies for minimising taxes, such as locating assets in tax havens or translating deduction allowances liberally, are no longer effective,' states JP Morgan's detailed study, *The Challenges of Wealth*.

'Many fortunes do not survive into the third generation, often because the relatives find it hard to manage their assets together effectively. A family with no clear decision-making process may be unable to cope with changes, whether gradual or sudden.

'A patriarch, with his wealth held in complex structures to minimise tax, may end up leaving a picture so opaque as to cause suspicion and strife among his heirs. Risk can arise when one person dominates decision-making. This powerful family member must pay attention to grooming future leaders, hiring professional managers and instituting appropriate family governance measures.

'Otherwise, an unexpected turn of fate, such as illness, disability or death, will quickly put the family wealth at risk. With effective planning, family members will be prepared for a wide range of possible futures – not just the one they deem most natural or most probable.'

One of the keys to passing on a larger inheritance is to involve younger generations in decision-making. JP Morgan recommends that family members should receive the information they need in a clear and readily understandable form: 'A simple summary of the family's goals, assets, cash flows and ownership is a fundamental level of information. Flexible ownership structures, such as family companies, partnerships and trusts, can reduce the family-dynamics risk by permitting some members to take an independent path. Each structure must have the governance process to ensure that it remains consistent with the evolving tax and regulatory environment.'

Plan ahead

Steve Harvey, senior manager of the trustee department at Coutts & Co, agrees: 'One of the most important things, in the UK at least is planning your tax as early as possible, because inheritance tax in the UK is based on the value of your estate.

'The nil band rate at the moment is £263,000, which isn't high when you look at property values. Making gifts out of your estate during your lifetime is one way of reducing the value of your estate and reducing the inheritance tax. You can also give away your money or set up charitable trusts. If you decide that you want to pay the tax, then perhaps you should put an insurance policy in place that covers the tax when it becomes payable.'

If you give your money away, say to a charitable trust, it is immediately out of your control. As Harvey says: 'If you set up a charitable trust, you can have no further interest in that trust. If you do, then you are deemed to be making a gift with reservation and it will not be an effective gift from your estate. However, we have a number of clients who have set up charitable trusts so that their goodwill goes on into perpetuity. Properly set up and managed, it's an effective means of reducing an estate.'

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If you believe that charity begins at home, transferring your wealth offshore won't necessarily prevent the taxman laying his hands on a large chunk of it. 'It is a false understanding that by transferring your money offshore you can literally escape the net – you can't,' says Harvey. 'The fact that you can transfer a large bank account deposit to Jersey, Switzerland or wherever, won't help. If you are resident domicile in the UK, you will still be liable on your death for that asset to be included in your estate and to pay inheritance tax on it. If you are a non-domicile of the UK who owns assets in the UK, they can become liable to inheritance tax if they are in excess of the nil rate band.

'There are ways around that one, if you're talking about non-domicile. One example would be if you had a property in the UK that was worth, say, £1m. You could own that property through an offshore company, which effectively takes the UK nature of the tax out of your estate. It gets a bit complicated, and it's not an ideal solution, but there are alternatives which you can explore in that direction.'

In the UK, inheritance tax is not only a tax on assets held at death, it also applies to gifts made by individuals within seven years of transfers into discretionary trusts. On death, transfers or gifts made in the previous seven years are added to the value of assets then held by the deceased and tax is assessed by referring to this total. Similarly, the total value of chargeable transfers made in the last seven years determines the tax payable on the last transfer.

Once seven years have elapsed since the making of a gift, it can generally be ignored. It is not then taken into account for the calculation of tax on later lifetime transfers, and is not added to the rest of the estate on death. 'This is why wealthy people really need to start planning for their inheritance tax as early as they can,' said Harvey, 'for then they can start using that seven-year period.'

A few people spend their time floating around the world like the Flying Dutchman and claim to be stateless. Is the concept of a stateless individual plausible from a tax point of view? 'That won't work because everybody has a domicile under UK law,' said Harvey. 'You can choose a domicile or country of choice as you move through life, and that's fine. You will always have a domicile, and if you return to the UK you will pick up that domicile again. Domicile is very important as far as inheritance tax goes. The chap who is wandering the seven seas on his yacht still has a domicile – usually the country where his father was born – and if he hasn't relinquished it, it will still apply.'

Marriage guidance

The good news is there is no inheritance tax payable on the transfer of assets between a husband and wife. However, whatever is passed on to the

Comparing duties

Inheritance tax, also known as estate tax in the USA and as death duty in other countries, is a form of tax levied upon the bequest that a person may make in their will to a living person or organisation. If a bequest is made to a charitable organisation, most countries do not apply the tax. The tax is also imposed on other transfers of property made as an incident of the death of the owner, such as a transfer of property from an interstate estate, or the payment of certain life insurance benefits.

In the UK, death duty was first introduced as a tax on estates in England and Wales over a certain value in 1796. It was then called legacy, succession and estate duties. Estate duty was replaced in 1975 by capital transfer tax, which was replaced by inheritance tax in 1986. The current rate is 40 per cent on the value of all estates over £263,000. On death, there is a minimum of 12 months of probate, during which solicitors assess the value of the estate and consider challenges. If there is insufficient cash to pay the tax and the solicitors' bill, then assets must be sold.

Death duty existed in Australia until 1981. In 1978, the premier of the Australian state of Queensland abolished inheritance tax in his state. The then prime minister of Australia, Malcolm Fraser, endorsed this action and abolished federal inheritance tax in 1978 as well. By 1981, inheritance tax had been abolished in all Australian states and territories. Australia continues to have no inheritance tax.

Canada has not had an inheritance tax since Brian Mulroney's government in the 1980s repealed it. It is treated as a sale.

In the USA, the Federal Government imposes an estate tax, which is calculated as a percentage of the net value of the estate after certain credits and deductions. On estates over $3m, the tax levels are around 55 per cent.

'WITH EFFECTIVE PLANNING, FAMILY MEMBERS WILL BE PREPARED FOR A WIDE RANGE OF POSSIBLE FUTURES'

next generation becomes taxable. 'Quite often in the UK a husband and wife will leave everything to each other,' says Harvey. 'That means if the spouse dies and leaves everything to the other, who then dies themselves, you then use the UK's nil rate band for the latter; everything else is attached at 48 per cent.

'If you do this, you aren't effectively using the nil rate band on the husband's death because everything's been transferred to the wife. A simple method of planning ahead is to actually make sure that the £263,000 nil rate band is used in both wills and you can do that by leaving £263,000 to your children and everything else to your wife or husband – that chargeable gift to your children falls within the nil rate band and there will be no tax payable. When your spouse dies, there is another £263,000 which can be used, and you pay tax on the balance.

'It is a simple and very effective planning tool and certainly when we see husband and wives in the UK it's the first thing we look at – making sure that the nil rate band is being used effectively. It can save about £100,000 in tax.' If the widow or widower remarries, the nil rate band rule apparently still applies, ad infinitum. 'That's why when anyone remarries they should take a close look at their wills,' says Harvey.

International duties

'Generally speaking, most countries have a form of exception duty or inheritance tax that is payable there,' says Linda Foster, tax partner at Deloitte. 'Inheritance tax is a UK term, and is also known as death duty or estate duty. Cross-border activities, which lead to property ownership in more than one country, can create enormous problems for individuals and their family. Individuals need to be aware of the domestic laws covering a large number of countries outside the UK. An individual about to embark on an extended stay abroad should use that occasion to consider such matters as his or her will, and in particular a will to cover his or her overseas assets.

'In this respect, the law governing succession is of vital importance, so the professional adviser should at least be aware of the fundamental differences that can occur between common law countries, such as England, and civil law countries, such as Spain. In some countries, succession problems can be easily avoided by holding assets in joint names, so that on death they pass automatically to the survivor without any need to obtain probate. However, this is not the norm.'

Indeed, Foster cites a startling figure. 'It is surprising how many people – about 95 per cent of them – will get a long way down the track of buying a property abroad before they ask questions or seek advice on the right way to own it. Some of our clients may be very shrewd when it comes to business, but when it comes to their own lifestyle it's often more of an emotional decision than a financial one.

'The major variation in all the rules is between common law and civil law jurisdictions. Under common law, such as the UK's, you can actually leave assets to whoever you like, even to a cat's home if it suits you, subject to somebody coming along later and saying that they were dependent on you. Civil law jurisdictions are much more prescriptive about the way in which assets must be left, and the state tax regimes are different in that the tax is on the recipient of the gift and not on the estate. If there's no estate, it's usually the children or parents who benefit, and the inheritance tax rates go up the further away you get. You may have difficulty in actually leaving anything to friends because it's prescribed as to how much you must leave the family.'

However, reassures Foster, by seeking good advice you should be able to find a way around these obstacles: 'We always suggest to individuals that they should have one main will to cover their global estate. However, we always double-check whether it is beneficial to have a satellite will in each country where they hold property, so that the two laws don't end up clashing. It's a lot cheaper in the long run to take some preliminary advice rather than sort it out after the event.' ☐