

# Inheritance Tax

**Inheritance Tax (IHT) is the only form of tax or duty imposed on the death of a person whose domicile is in the UK. For many years the tax was known as estate duty. In 1975, this was changed to capital transfer tax to reflect the fact that it affected not only the property that passed from one person to another on the former's death, but was also a tax on the larger gifts that people made in their own lifetimes.**

IHT is charged at 40 per cent and is liable to be paid on the value of an estate (including certain gifts and trust assets) that is more than £325,000, or £650,000 for married couples and civil partners (2011–12). Estates that are valued at less than £325,000 are in the 'nil-rate band'.

One of the reasons for making a will is to reduce the IHT that might be charged on your death or, later, on the death of your spouse or civil partner. It is important that you understand the tax well enough to know if you are going to be affected by it.

This book also suggests a number of ways to potentially reduce the incidence of IHT so that you can discuss the matter thoroughly with your solicitor or your independent financial adviser (see pages 29–34 and 70).

## WHEN IS IHT PAYABLE?

On a person's death, IHT is charged on the value of his or her net estate in excess of the nil-rate band – that is, all his or her property and assets less all his or her liabilities and debts (see page 19). (The funeral costs can also be deducted.)

The Inheritance Tax Act 1984 (originally known as the Capital Transfer Tax Act 1984) states that IHT 'shall be charged on the value transferred by a chargeable transfer'. To prevent people giving away all their property immediately before they die in a bid to avoid the tax, the rules provide that IHT is calculated not only on the value of the property that a deceased person has when he or she dies but also on the running total of gifts ('transfers') over the last seven years. So, when calculating the size of an estate, it is important to look at all the gifts made



**If you have a complex or very large estate, get professional advice on ways to minimise paying IHT. Contact either a solicitor or a member of the Society of Trust and Estate Practitioners (STEP) (see page 41).**

in the seven years up to and including the gift on death. The tax is applied first to these gifts and then to the estate. The effect is often to use up the nil-rate band on the gifts so the tax payable on the estate is increased (see the example on page 32). IHT relates mainly to property passing on death but also affects lifetime gifts, unless they fall into an exempt category (see tax-free gifts, right).

The value on which IHT is charged also includes the capital value of any **trust** set up before 22 March 2006 in which the deceased had a **life interest** or was entitled to the income or was entitled to the use of property, such as a home. (Most life interest trusts set up on or after that date do not count as part of

the estate unless they have been set up by a will.)

The amount of any taxable gifts made by the deceased up to seven years prior to the death or even earlier gifts if an interest or benefit has been reserved is also added back to give the total value upon which IHT will be levied.

## TAX-FREE GIFTS

The following gifts do not need to be taken into consideration when calculating what needs to be added to an estate from gifts given over the last seven years of a deceased's life. As such, they are useful to know about for will planning.

- **£3,000 per annum**, all or part of which can be carried forward for one year if unused (every individual has this allowance). Gifts always use up this year's allowance first before any carried forward part.
- **Small presents** – any number of individual gifts of up to £250 per recipient can be made each year in addition to the annual allowance of £3,000. Note that the same person cannot receive £3,000 as well as £250 under these provisions.
- **Gifts to a spouse or civil partner** – all property passing between husband and wife or between civil partners. Any property that passes from one spouse

### Jargon buster

**Life interest** A gift that gives someone the right to income or occupation of an investment or property for the life only, after which the asset goes to the ultimate beneficiary(ies) named in the will (known as the remaindermen)

**Trust** A legal arrangement under which assets are looked after by trustees for the benefit of the beneficiaries upon the terms set out in the trust document or will. A life interest with ultimate beneficiaries is an example of the terms



*Giving and Inheriting*, a Which? Books guide is another invaluable source of information on the topic of Inheritance Tax.

to another by gift in their lifetime, or to the survivor on the first death is wholly exempt from IHT. This provision does not apply to unmarried couples or unregistered same-sex couples.

- **Gifts to a person in consideration of their marriage**, up to £5,000 per parent, £2,500 per grandparent and £1,000 from anyone else.
- **Normal expenditure out of income** – what is normal expenditure depends on the income and spending habits of the giver, but this can be a valuable exemption.
- **Charities** – all gifts, regardless of size, by will to charity are wholly exempt from IHT.
- **Political parties** – gifts in lifetime or by a will to established political parties are exempt. The condition is that the party has at least 2 MPs or polled at least 150,000 votes at the most recent general election, so it need not be to one of the main parties.
- **Gifts in lifetime or on death to the nation** or of public benefit – gifts to certain national museums or collections and some objects or property of national importance are exempt if they are accepted.
- **Gifts in lifetime or on death to housing associations.**
- **Gifts in lifetime for maintenance of family.** (These are subject to detailed provisions as laid down in the Inheritance Act 1984.)
- **Transfer of pools and lottery wins** according to an agreement made before the win.

There are also a number of variable exemptions or 'reliefs' affecting such types of property as Lloyd's underwriting accounts, farmland, forestry and timber, sole trader and partnership businesses and family company shares. You should get advice from a solicitor or accountant if you are involved with any of these. The qualification rules for these reliefs are complicated and so is the calculation of the figures involved, so seek further guidance from an expert.

## POTENTIALLY EXEMPT TRANSFERS (PETS)

In addition to the tax-free gifts listed above, you are permitted to give lifetime gifts to individuals that remain tax-free – as long as you survive for seven years after giving them. But PETs given over the last seven years of your life are included in the value of your estate when assessing any IHT liability. The gifts are treated as

### Insuring against a PET

**A beneficiary of a lifetime gift in excess of the nil-rate band might want to consider taking out a form of term life insurance payable to the beneficiary so that, if the donor dies within the seven-year period, the policy will provide an amount equal to the tax that would become payable. This is only relevant where the lifetime gifts of the donor exceed the nil-rate band, taking into account the running total of gifts over seven years.**

the first slice of the estate for calculating IHT. For example, a gift of a house worth £400,000 two years before death with an estate of £100,000 results in tax of £30,000 on the gift and £40,000 on the estate. The total IHT payable is the same as for an estate of £500,000 with no gifts, but the tax is distributed between the estate and the recipient of the gift. If the gift had been £100,000 and the estate worth £400,000, the recipient would pay nothing because the gift, as the first slice of value charged to the tax, would fall in the nil-rate band. Only £225,000 of the nil-rate band would be available to the estate, so IHT of £70,000 would be payable out of that (£400,000 less £225,000, at 40 per cent).

On lifetime gifts to companies or to any type of trusts, tax is payable when the gift is made at the reduced lifetime rate of 20 per cent, unless, when added to the running total of gifts in the preceding years, it falls within the nil-rate band:

- **If the person making the gift dies within seven years**, tax is recalculated at the death rates and any extra tax due is collected (though there may be some reduction where death occurs between three and seven years after making the gift – tapered relief (see box, right)). If the recalculation results in a lower tax bill, the tax already paid cannot be recovered.

## Tapered relief

**This relief applies where a person makes a PET in excess of the nil-rate band but then dies after at least three years. This also applies to chargeable gifts (e.g. gifts to trusts) where 20 per cent tax was paid at the time, but on the donor's death within seven years, tax is recalculated at the death rates. In such a case, the IHT due on the value of the gift will be reduced by:**

- 20 per cent if the death occurs in the fourth year
- 40 per cent in the fifth year
- 60 per cent in the sixth year
- 80 per cent in the seventh year.

**It is important to realise that this relief applies only to the amount by which the gift, when added to the total of gifts in the previous seven years, exceeds the nil-rate band.**

**If the gift falls within the nil-rate band, there will be no tapered relief because no tax is due.**

**Any tax that is due is paid by the person who received the gift. If the beneficiary can't (or won't) pay the bill, the sum comes out of the estate of the deceased donor.**



**It can be possible to make IHT savings by writing a deed of variation after the testator has died. See pages 78–9 for a full explanation.**

## DISPOSING OF PROPERTY TO SAVE IHT

A lifetime gift of a parent's own main residence to a son or daughter is not an effective gift for saving IHT if there is any understanding that the parent is allowed to go on living there free of charge, because that amounts to 'reserving an interest'. However, giving away a house unconditionally and excluding the donor from benefiting in any way, or perhaps even a second home where the question of the giver remaining there would not even arise, could lead to considerable tax saving (but watch out for Capital Gains Tax (CGT) (see box, right) if you are thinking of giving away a second home).

A relatively new piece of legislation, known as the Pre-Owned Assets Tax (POAT), is now in existence. It stipulates that there should be an annual income tax charge on those who have divested themselves of assets (to reduce IHT liability), in circumstances in which they are still able to enjoy the assets that have been given away but the gift is not caught by the **reservation-of-benefit rules**. The charge is based on a notional rent from land or income from other assets. It catches a number of tax-avoidance schemes but should not affect a situation in which a property is given away and the person giving it then pays a proper rent, or one in which a person gives a half-share in a property and the person receiving the gift moves in and shares the expenses. Although the new legislation is complicated, it cannot be ignored by those seeking ways to avoid

paying IHT. If you are thinking of giving your home to your children, but intend to continue living in it, take advice.

The changes to the IHT rules in 2008 make it possible for a person to make a will leaving their entire estate to their spouse or civil partner without wasting their nil-rate band. However, there can be several reasons why this is not a good idea. For example, your spouse or civil partner may be in a nursing home or you

### Jargon buster

**Reservation of interest** Where a gift is made but the person making the gift continues to enjoy some benefit from the gifted property or asset, e.g. if you continue to live rent free in the house you have given away or if you give away a valuable picture but keep it hanging on your wall



If an asset's value at the time you give it away is greater than its value at the time you first started to own it, you could be liable to pay Capital Gains Tax (CGT) on that difference. There are, however, exemptions and ways to mitigate this, so if you have any concerns, discuss the situation with your solicitor.

might have children from an earlier marriage who you will need to make special provisions for. Remember, the intestacy rules have not changed. If the estate is worth £325,000, without a will the surviving spouse or civil partner with children will only receive capital of £250,000, not £325,000 (see page 143 for further information).

## OTHER WAYS OF SAVING IHT

There are other ways in which IHT may be saved, but these are more elaborate and beyond the scope of this book – see the *Which? Books* guide to *Giving and Inheriting* for more details.

It may be helpful to give an example. This also illustrates the subtlety of the questions that arise when planning for tax is attempted.

Suppose a divorcee and a widower marry, each having some wealth and a grown-up family. Suppose the widower dies first. On his death he will be entitled to pass on £650,000 without IHT (his own nil-rate band plus that of his first wife, assuming that she left everything to him). As he wants his wealth ultimately to pass to his own family, one possibility is a will for him giving £650,000 to a discretionary trust. The trustees can be invited to ensure that his second wife is adequately provided for from the £650,000, perhaps by receipt of its income, before any question of distribution to his family arises.

On the death of his present wife she will have her own nil-rate band. She will not inherit any of his nil-rate band

because it is all 'used' by the gift to the discretionary trust. A total of £975,000 therefore falls within nil-rate bands and escapes tax.

There is another possible configuration. Suppose he gave only £325,000 to the discretionary trust and he gave his present wife a life interest in the remainder of his estate. If the will gives the trustees authority to partially terminate the life interest, it is possible for his family to benefit before the death of the second wife. If this is done more than seven years before her death, it effectively counts as a PET by her and escapes tax entirely. The advantage of this way of doing things is that she will inherit one of his unused nil-rate bands, so a total of £975,000 escapes tax and there is a chance of more, if she survives long enough.

This kind of planning should not be attempted without professional advice.



**The government may revise these rules from time to time and may pass legislation that would severely restrict these possibilities. It is essential, therefore, to be up to date with legislation and any case law that may affect tax-avoidance schemes.**