Steeles Law
Solicitors

Guide

Inheritance Tax Explained

Inheritance Tax (IHT)

1. IHT is a form of death duty that is payable at the rate of 40% on the amount by which a deceased person's estate exceeds the Nil-Rate Allowance (£325,000 at 6.4.2009).

2. A person's Nil-Rate Allowance may be reduced by the value of gifts made by them during their lifetime, life policies and pension funds, and certain trusts in which they have an interest.

3. The Nil-Rate Allowance is normally adjusted annually in line with inflation, and various exemptions and reliefs are available, as set out below. IHT is also payable during lifetime on gifts into certain trusts.

IHT Exemptions and Reliefs

Nil-Rate Allowance

4. Everyone has their own Nil-Rate Allowance and can dispose of assets up to that value, by Will or by lifetime gifts, free of IHT.

5. Spouses and Registered Civil Partners (referred to in the remainder of these notes as 'RCPs') are separately taxed. They each have their own Nil-Rate Allowance and in addition, benefit from Surviving Spouse Exemption and Transferable Nil-Rate Allowance, as explained below.

Surviving Spouse Exemption

6. Anything that spouses or RCPs give to each other by Will, or during their lifetime, is exempt from IHT, provided that both are UK-domiciled.

Transferable Nil-Rate Allowance

7. If the first to die of a married couple or RCP has not used all of their Nil-Rate Allowance, the unused portion can be claimed by the executors of the surviving spouse or RCP, as a proportion of the Nil-Rate Allowance in force when the survivor dies.

8. If the first to die did not use any of their Nil-Rate Allowance, this will mean that the survivor's estate will benefit from an allowance of double the Nil-Rate Allowance in force at the time of their death (i.e. £650,000 at 2009/10 rates). In addition, even if the value of the estate of the

first to die was considerably below the Nil-Rate Allowance, the full amount can still be claimed by the survivor's executors.

9. As long as the second death occurs after 9th October 2007, it does not matter how long ago the first death took place. The surviving spouse or RCP should take legal advice following the death of their spouse or partner, to secure their unused Nil-Rate Allowance.

Agricultural Property Relief

10. Subject to certain conditions being fulfilled, Agricultural Property Relief is available on farm houses, land and buildings occupied by working farmers, and effectively reduces the value of the land and buildings for IHT purposes. The value is reduced by 100% if the property has vacant possession or if the landlord is entitled to it within twenty four months, or if the property was let after 1st September 1995 (i.e. on a Farm Business Tenancy). The value is reduced by 50% if the property was let prior to 1st September 1995.

Business Property Relief

11. Business Property Relief may be available at 50% or 100% on the value of a business, a share in a partnership or company, or land used in a business, partnership or company, subject to certain specific conditions being fulfilled. Certain types of businesses will not qualify, so advice should be taken in each case.

IHT Mitigation: On Death

12. If Spouses and RCPs have a combined estate worth more than twice the Nil-Rate Allowance, they cannot save further IHT by any provisions contained in their Wills, other than charitable legacies.

Cohabitees

13. Co-habiting couples, however, do not have the benefit of transferable Nil-Rate Allowances. If a cohabitee inherits all of their partner's estate (whether by Will or by automatic transfer of jointly-held assets), IHT will be payable on everything over the Nil-Rate Allowance. When the second cohabitee dies, IHT will be payable on the value of the combined estate over the Nil-Rate Allowance. Cohabitees may be able to save IHT by including a Nil-Rate Trust in their Wills – see below.

Nil-Rate Trust

14. Instead of leaving the bulk of their estate to their partner on their death, cohabitees could leave assets to the value of the Nil-Rate Allowance on trust, for the benefit of their partner and/or their children. The advantages of doing so are that the taxable value of the estate of the second to die will be smaller (as it will not include the assets in the trust), and the trust will provide some security for the surviving partner. Please speak to us for more information about Nil-Rate Trusts.

Charitable Legacies

15. Legacies to registered charities and major political parties are exempt from IHT.

Deeds of Variation

16. If an inheritance is due from the estate of a deceased person, this may add to the IHT burden on the beneficiary's own estate. That beneficiary can, within 2 years after the death of the deceased, redirect their inheritance (e.g. into a discretionary trust from which they may benefit or to their children) by a Deed of Variation. There is an immediate IHT-saving as the inheritance is treated for IHT purposes as never having formed part of the beneficiary's estate. Deeds of Variation can also be made by the executors of a deceased beneficiary.

IHT Mitigation: Lifetime Gifts: Exempt Transfers

Three Categories of Lifetime Gifts

17. Gifts made during lifetime can reduce the value of an individual's taxable estate, and this applies equally to married couples, RCPs, cohabitees and single people. Lifetime gifts fall into three categories – 'exempt transfers', 'potentially exempt transfers' (PETs) and 'immediately chargeable transfers'. Married couples and RCPs each have their own individual exemptions. The types of exempt transfers are set out below.

Types of Exempt Transfers

18. Gifts between spouses and between RCPs are exempt from IHT (provided that both are domiciled in the UK).

19. Individuals can give away up to £3,000 per tax year, free of IHT. If the exemption is not used up in any one year, it can be carried forward but for one year only, and used in the following year after that year's exemption has been used in full.

20. Individuals can make as many outright gifts as they like, up to a total of £250 per beneficiary, each tax year.

21. Individuals can make regular gifts from income provided that their usual standard of living is not reduced and they do not use capital. There should be a pattern to the gifts e.g. premiums paid on life policies written in trust.

22. Certain gifts made to bride or groom at, or shortly before, their wedding are exempt as follows: £5,000 from a parent, £2,500 from a grandparent or great-grandparent and £1,000 from anyone else.

23. Gifts made for maintenance of a dependent relative are generally exempt.

24. Gifts of any amount to registered charities and major political parties are exempt.

IHT Mitigation: Lifetime Gifts: Potentially Exempt Transfers

What is a 'Potentially Exempt Transfer'?

25. If a transfer does not fall within any of the exempt categories, it may be a 'potentially exempt transfer' (PET). The main feature of a PET is that if the person making the gift ('the Donor') survives the gift by 7 years, no IHT will be payable on the value of the gift. PETs can be gifts to other individuals but gifts into trusts are Immediately Chargeable Transfers, with the exception of trusts for certain disabled beneficiaries.

Death within 7 Years of Gift

26. If the Donor does not survive for 7 years after making a PET, the value of the gift (at the date it was made) is added to the Donor's estate for the purpose of calculating IHT.

27. If the total value of PETs made by the Donor within the period of 7 years before death exceeds the Nil-Rate Allowance, IHT will be charged on the excess as follows:

    27.1. If the Donor survives for more than 3 years but less than 7 years after making a PET, IHT will be charged at a percentage of the rate of tax applicable at the date of death, on a sliding scale.
    27.2. However, if the Donor fails to survive for 3 years after making a PET, IHT will be payable at the full death rate.

An IHT saving will only be made, therefore, if the asset given away has increased in value, or produced an income for the recipient.

28. The recipient of the failed PET is normally responsible for paying the tax. There may be further complications if the Donor had made any immediately chargeable transfers within the 7 years before the earliest of the failed PETs.

IHT Mitigation: Lifetime Gifts: Immediately Chargeable Transfers

29. Gifts which are not exempt transfers or PETs are immediately chargeable transfers (CTs). This includes gifts into most types of trust.

30. If a Donor makes a CT, which exceeds the Nil-Rate Allowance, an immediate IHT charge arises of 20% of the excess.

31. Tax treatment of trusts is a complex area and Donors must take specific advice on their individual circumstances.

Disadvantages of Lifetime Gifts: Reservation of Benefits

32. All gifts must be unconditional, and the recipient must be able to use the asset as he or she wishes. If the Donor continues to use or benefit from the asset (for example, by giving their house to their children but continuing to live there) this will be a 'reservation of benefit' and the asset will continue to be treated as part of the Donor's estate for the purpose of calculating IHT.

33. Possession and enjoyment of the asset given must be assumed by the recipient at the date of the gift, to the entire exclusion or virtually to the entire exclusion of the Donor.

Disadvantages of Lifetime Gifts: Capital Gains Tax (CGT)

34. The gift of certain assets such as shares, land or buildings, will be a disposal for CGT purposes, despite the fact that the Donor has not received any payment. The Donor is deemed to have disposed of the asset at its open market value, and CGT is payable on the difference between this and the value when the Donor acquired it or at 31st March1982 if later (the base year).

35. The Donor's 'principal private residence' and grounds up to 0.5 hectares are exempt from CGT, provided certain conditions are satisfied.

36. Individuals have an annual CGT-free allowance of £10,100 (at 06.04.09), above which gains are taxed at a flat rate of 18%.

37. Taper relief and indexation allowance, which had the effect of reducing chargeable gains, were withdrawn with effect from 6th April 2008. Entrepreneurs' Relief may apply to qualifying disposals of businesses and business assets from 6th April 2008.

38. The CGT rules are complex, and advice should be taken on the specific circumstances in each case.

Interaction with Other Taxes

39. The effect of Pre-Owned Assets Tax and Stamp Duty Land Tax may also need to be considered in any IHT planning.

More details are available upon request.

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