

Inheritance Tax – An introduction

Introduction

Inheritance Tax (IHT) is in simple terms a tax on your estate. It is a combined gift tax and death duty charged on the assets you own when you die and can include any gifts you make in the seven years before your death. Inheritance tax is a complicated subject and therefore this fact sheet provides a brief summary of inheritance tax and some areas that can be used to help mitigate it, you should seek professional advice if you wish to consider any form of inheritance tax planning.

The rate of IHT

The rate at which IHT is levied is 40% on anything above the 'nil rate band'. This means that currently, the first £325,000 is not taxed but anything above this figure is taxed at 40%. As an example, if you were to leave an estate of £725,000, the inheritance tax payable could be £160,000. There are several reliefs and exemptions available that can be used to help mitigate any potential inheritance tax bill.

Residence Nil Rate Band (RNRB)

The Residence Nil Rate Band can be used in addition to the standard Nil Rate Band, if certain qualifying conditions are met. It is available on deaths on or after 6 April 2017. The current rate is £175,000 per person.

For married couples and civil partners, any unused Residence Nil Rate Band can be transferred if the surviving spouse or civil partner dies after 5 April 2017 irrespective of when the first of the couple died.

Broadly, the Residence Nil Rate band is available if a person's estate includes their home and it is left to their children or other direct descendants. The legislation refers to property being 'closely inherited'. The amount of Residence Nil Rate Band available is limited to the value of the home that is left to the direct descendants.

There is no requirement for a claim to be made for RNRB. If the conditions are met, then it is due automatically.

The Residence Nil Rate band is tapered down if an estate is greater than £2,000,000. This means that for every £2 over that limit, the Residence Nil Rate band is reduced by £1, this means for estates that exceed £2,350,000, there is no Residence Nil Rate Band.

The annual exempt amount

The first £3,000 of gifts that you make in any tax year are free of IHT. This exemption may also be used to cover part of a larger gift. Both husband and wife have separate annual exemptions. Any unused balance can be carried forward into the next tax year but only after the exempt amount for that tax year has been used up.

Small Gifts

Gifts you make which do not exceed £250 to any one recipient in any tax year are classed as 'small gifts' and are tax-free. There is no limit on the number of such small gifts which you can make tax free providing they are made to separate individuals otherwise where your gifts to an individual exceed £250, the exemption is lost completely. You cannot combine this exemption with any other exemption to cover a larger gift.

Gifts made out of income

Gifts made out of your income, forming your normal expenditure, as opposed to those which draw on your capital are free of IHT. The legislation requires that your gift should be normal, i.e., that you had a habit of making such gifts. It is also a requirement that you should be left with sufficient income to maintain your normal standard of living.

Gifts on Marriage

Gifts on the occasion of a marriage are exempt within the following amounts:

- £5,000 from you as a parent of the bride or groom
- £2,500 from you as a grandparent of the bride or groom
- £1,000 from you as other than the above

You may make gifts to either party of the marriage, not just your own child or grandchild.

Gifts to Charities

Any gifts that you make to charities, which are established in the United Kingdom, are tax-free. This also applies to gifts that you make for national purposes (e.g. colleges and universities, the National Trust, the National Gallery and the British Museum), gifts for public benefit.

Gifts between Husband and Wife or registered civil partners

You and your husband or wife/ civil partner are treated as separate individuals and you are each chargeable in respect of your own transfers but not to each other. Transfers between you at death are also exempt. You each also have a separate entitlement to all of the other allowances and reliefs.

Non-domiciled spouses

Where your gift is to a foreign domiciled husband or wife this is limited to £325,000. However, such a spouse maybe 'deemed domiciled' if he or she has been a UK resident for 17 out of the last 20 years.

Special Relief

Certain classes of business property qualify for relief in that the taxable value of such property is reduced. Your accountant or Financial Adviser will be able to explain this in more detail if this is applicable.

Potentially Exempt Transfers (PETs)

Irrevocable gifts to others that you make during your lifetime, **if not covered by any exemption**, are usually Potentially Exempt Transfers (PETs). This can include gifts that you make into a trust.

PETs are not subject to IHT at the time that you make them, but tax is paid on the PET (by the person you gave the gift to) if you die within seven years. If you make a PET and **survive for a further seven years** after the gift was made it becomes an exempt gift and no Inheritance tax is due. However, if you do die within seven years, **'taper relief' may reduce the amount of IHT payable**.

There is a sliding scale, which reduces the value of the gift that is brought back into the estate to calculate the value of your estate for inheritance tax purposes.

0-3 years - 100%
3-4 years - 80%
4-5 years - 60%
5-6 years - 40%
6-7 years - 20%

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Whether taper relief will actually reduce the IHT depends on whether the particular gift, in addition to other PETs made during the seven years prior to death, is in excess of the nil rate band. Where an individual has made a number of PETs, in the seven-year period preceding death, these are offset against the available nil rate band **in strict chronological order**. (more details or available on request).

Reservation of Benefit

A gift with reservation of benefit is one where the person who donates the gift still retains (or reserves – i.e. the 'reservation') some benefit in relation to the gift. For example, in perhaps the most common scenario you may give your house away but continue to live in it rent-free. In this case the house will still be liable for taxation as part of your estate. However, if you paid a commercial rent and were to live the seven years, it may be considered exempt. Ultimately it would be for the Inland Revenue to decide and this is an area where specialist legal advice is required.

Using your Spouse's Nil Rate Band

A transferable nil rate band is only available to spouses and registered civil partners and was introduced in the Finance Act 2008 and applies in all cases where the second death occurred on or after 9 October 2007. Generally, when the first spouse dies the remaining estate is passed across to the surviving spouse. The main IHT problem usually occurs when the surviving spouse dies, and the estate is passed to children or others.

The IHT situation for many married couples has been eased as the result of the introduction of this 'transferable nil rate band', which means that your estate can not only have your own 'nil rate band' applied against it but also the unused portion of your late spouse's nil rate band as well. In a nutshell it means that a husband and wife can leave £650,000 (2 x £325,00) to their beneficiaries before any inheritance tax would be due. A claim for this has to be made on second death by the executors within 24 months after the end of the month of your death.

Deed of Variation

A Deed of Variation enables beneficiaries of a deceased's estate to alter the distribution of that estate or relinquish a bequest from an estate. Thus, changing the deceased Will.

There are several reasons that you might want to alter the way money is allocated from a deceased estate but probably the most common reason to make an alteration is to achieve a future Inheritance Tax saving. The Deed of Variation must be effected within two years of the death of the individual to be effective for inheritance tax purposes.

To establish a Deed of Variation all the beneficiaries of the will must agree. If minors are involved this is further complicated as they cannot themselves consent to the changes and an application must be made to the courts for consent to be obtained on their behalf.

A Deed of Variation can be used to reduce an inheritance tax liability. If the assets are passed to an individual who may have an inheritance tax problem themselves, they could elect to have the assets passed to their children instead, thereby reducing their estate. If this is the case the individual who has foregone the legacy is not deemed to have made the gift but instead it is the deceased who is deemed to have made the transfer.

The information contained within this fact sheet provides a brief overview of this subject and should be considered as a guide and in no way constitutes any type of advice. The information is based on our current understanding of legislation and correct at the time of publication which is 25th January 2021. If you require any further advice on this subject please call us on 01372 371030.

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