

Quick guide to inheritance tax

Introduction

Inheritance tax is generally paid at:

- 40% on inheritances when someone dies, and
- 20% on lifetime transfers into a trust (see below).

These rates have not changed since the tax was introduced in 1984. However, for deaths from 6 April 2012, a new rate of 36% is planned where at least 10% of the estate is given to charity.

In each case, the rate of tax only applies for transfers over a nil rate band limit. This is currently £325,000. This government has said that this limit is fixed until 2014.

Many inheritance tax computations are very simple. Suppose someone dies leaving an estate worth £1 million. The inheritance tax payable is:

estate worth	£1,000,000
less nil rate band	<u>£325,000</u>
taxable estate	<u>£675,000</u>

Tax: £675,000 x 40% = £270,000.

And that's it.

However there are other factors that can make inheritance tax a little more complicated.

Lifetime gifts

An obvious way for a dying person to avoid inheritance tax is simply to give everything away before death.

There is a general rule that any gift made in the seven years before death is added back to the estate. If made more than three years before death, there is some relief. So if you gave your son £50,000 on 1 July 2010, this will be added back to your estate if you die before 1 July 2017.

A gift made during your lifetime is called a **potentially exempt transfer** or PET. It is exempt, provided you live another seven years.

There are many exceptions to this rule where you can make gifts that are not added back on death. These are:

- **annual allowance** of £3,000 a year. If the allowance is used for the current tax year, you can use any unused allowance from the previous year. Otherwise unused allowance is lost;
- **small gifts allowance** of £250 per person per year. You may make a gift of up to £250 to any number of people in a year;
- **marriage gifts** of £5,000 for a parent, £2,500 for a grandparent, £1,000 for anyone else;
- **normal expenditure out of income**;
- **maintenance** payments for current or former family.

Apart from the small gifts allowance, these allowances can be combined.

It should be noted that these limits have remained unchanged since the tax was introduced in 1984. Indeed many of them are unchanged from previous taxes.

Be careful in making a gift where you retain any benefit, such as by giving away your house after granting yourself a lease to live in for the rest of your life. Such a gift is called a **gift with reservation (GWR)** and is usually regarded as not being a gift at all.

Even if not caught by the GWR rules, there are now rules on **pre-owned assets**. If you owned something and then give it away but continue to receive a benefit, you could be liable to pay *income tax* (not inheritance tax) on the value of the benefit. This could apply if you give your daughter a holiday home but she lets you stay there for a couple of months each year.

Something is only a gift if there is **gratuitous intent**, that is you intended to provide an element of gift. So ordinary arm's length sales are not included. Waivers of dividends and remuneration are usually not regarded as gifts, provided certain conditions are met.

Exempt transfers

Some inheritances are always free of inheritance tax.

This includes gifts between husband and wife, or between civil partners. These are always free of inheritance tax (unless the inheriting partner is non-domiciled, in which case only the first £55,000 is tax-free). There is also now a transfer of the nil rate band between spouses.

Other tax-free inheritances are:

- gifts to charities and some other bodies,
- gifts to one of the main political parties,
- gifts of decorations for valour or gallantry from the original recipient.

The estate of someone killed on **active service** is exempt from inheritance tax. This provision is wider than is often realised. In particular:

- the death does not have to be instant, and
- the injury does not have to be the sole cause.

In 1944 the fourth Duke of Westminster was shot in the stomach, as a result of which he contracted septisemia. In 1967 he died from cancer which was exacerbated by the septisemia. That was enough for his large estate to be exempt from the equivalent to inheritance tax.

A **business** that has been owned by the deceased for at least two years is also often outside the scope of inheritance tax. There are many rules in this area, for which advice should be sought.

Domicile

Someone domiciled in the UK pays inheritance tax on all property, wherever in the world situated. Someone not domiciled in the UK pays inheritance tax only on property in the UK.

Domicile is the country you regard as your natural home. You can have only one domicile, unlike residence. It is usually the country where you were born, but you can establish a **domicile of choice** in another country.

In practice, it is difficult to lose a UK domicile. There is no simple test, but almost any continuing connection with the UK could compromise a claim that you are no longer UK-domiciled.

There is also a **deemed domicile** rule (in Inheritance Tax Act 1984 s267) where you are regarded as UK-domiciled if you have lived in the UK for 17 of the last 20 years.

Value of the estate

The general rule is that the value of a gift for inheritance tax purposes is the loss to the estate, not the benefit to the recipient.

In many cases, these will be the same. The most common exceptions are:

- shares in a company which reduce a holding, say from 60% to 40% so that control is lost,
- items that form part of a collection.

There are special methods for valuing quoted and unquoted shares.

If quoted securities are sold at a loss within 12 months of death, the sale proceeds may be substituted for the estate value.

If land is sold at a loss within four years of death, relief may be claimable.

The value of the estate is reduced by the reasonable costs of the funeral, and any **debts** left by the deceased. It should be noted that there is a general rule that a debt is not allowed if the deceased made a gift to a person who then made a loan back to the deceased.

Disclaimers and variations

A person may disclaim an inheritance. They may have no room for a grand piano, or not want to look after a horse. Where an inheritance is disclaimed, it is treated as if it had not been left to that person.

It is possible for the beneficiaries to sign a deed of variation within two years of death. This deed can then be used as the basis for inheritance tax.

Taper relief

If someone makes a **potentially exempt transfer (PET)** and dies within seven years, the PET is added to the value of the taxable estate.

If the death was more than three years before death, taper relief reduces the amount of tax payable according to the number of whole years between gift and death:

Number of years	Taper relief
Three	20%
Four	40%
Five	60%
Six	80%

Quick succession relief

If someone dies soon after inheriting, the inherited assets could be subject to inheritance tax twice in a short time.

To allow for this, quick succession relief reduces the tax payable where the second death is within five years of the first. The amount of relief depends on the number of whole years between the two deaths:

Number of years	Quick succession relief
0	100%
1	80%
2	60%
3	40%
4	20%

Transfer of nil rate band

What would often happen is that a married couple would make mutual wills leaving everything to each other, and then to the children. Suppose the husband died first. His estate would pass to his wife free of inheritance tax. She then dies leaving perhaps £500,000 to their children. Of this £325,000 would be tax-free, and the estate would pay £70,000 on the rest.

In effect, the husband's nil rate band was wasted. To prevent this, various forms of **nil rate band trust** were developed. The trust was usually created by a clause in the will.

A surprise change in the law allowed unused nil rate bands to pass between husband and wife (or between civil partners) where the second death is after 8 October 2007. This rule applies regardless of how long ago the first death was.

The calculation involves:

- finding out how much of the nil rate band was unused at the first death,
- calculate this as a percentage of the nil rate band at the time, and
- add that percentage of the current nil rate band to the estate.

For example, a husband dies leaving £160,000 unused of the nil rate band that was then £200,000. This means that 80% of his nil rate band was unused. So when the wife dies, her nil rate band is 180% of £325,000. This is £585,000.

Had a nil rate band trust been used, it is possible that only £160,000 of the nil rate band would be available. So the wife's estate would pay tax after £485,000. By seeking to avoid inheritance tax, the couple could end up paying more!

If you are married or in a civil partnership, it is worth checking this point, particularly if the will was made before 9 October 2007.

Nil rate band trusts do still have a place. They can be used by unmarried couples, or to shelter an asset expected to appreciate significantly, such as a business or a property. This is an area where proper advice should be sought.

Trusts

The law on trusts changed significantly for inheritance tax purposes on 22 March 2006.

Before this date there were **discretionary trusts** that were subject to some rules imposing various inheritance tax charges. A discretionary trust is, as the name suggests, a trust where the trustees have discretion in how to apply the funds. It was widely used for tax planning.

Then there were other types of trust such as **interest in possession trusts** (typically where someone is allowed to use assets for their lifetime and then it passes to someone else), and **accumulation and maintenance trusts** (to provide for children up to the age of 25).

From 22 March 2006, a new class of trust was created known as the **relevant property trust (RPT)**. This included all discretionary trusts and many other types of trust that have previously not been subject to the tax charges. This is a specialist area of tax law and tax planning.

An **RPT** is subject to these inheritance tax charges:

- the 20% lifetime rate to the extent that the amount paid into this trust and certain previous trusts exceeds the nil rate band,
- a periodic charge every ten years, and
- an exit charge when the trust shuts down.

The 20% payable on the creation of the RPT is a potentially exempt transfer. That means that if the transferor dies within seven years, this amount is added back to his estate. This could mean that the other 20% becomes payable.

The periodic charge is calculated at a maximum of 30% of the lifetime rate. As this is 20%, it means that the trust suffers inheritance tax at up to 6% every tenth year.

The exit charge is a pro rata final periodic charge. If the trust shuts down four years after the last periodic charge, an exit charge of 4/10 of a periodic charge is payable, in this case 2.4%.

Payment

Normally the liability to pay inheritance tax rests on the donor. The will may say otherwise. Great care should be taken on this point, particularly when the estate is split between those not eligible to pay inheritance tax (such as a spouse or charity) and those who are.

Inheritance tax is generally payable six months after the end of the month of the death or lifetime transfer into a trust.

There is a special scheme allowing banks to release funds to pay inheritance tax before probate or letters of administration have been granted.

For certain types of property, there are options allowing payment to be made in up to ten annual instalments.

Inheritance tax is subject to rules about due dates, with the usual interest and penalty provisions.