

A Guide to Inheritance Tax



A Guide to Inheritance Tax

Inheritance Tax (IHT) is a tax payable on the worldwide assets of any UK domiciled individual on their death. There are currently three rates applicable; 40% on death, 20% on Chargeable Lifetime Transfers and 0% on assets up to the current nil rate band.

Effectively, for most individuals Inheritance Tax is payable at a rate of 40% of the value of their total estate, less the 'nil rate band', which is £325,000 in the 2010/11 tax year. This nil rate band figure is frozen at £325,000 for the next 4 years, up to and including 2014/15.

There are a number of exemptions and allowances, which are;

- Availability of deceased's partner's unused nil rate band on second death. Inheritance tax was introduced with effect from 18 March 1986 but before this date other estate taxes (Capital Transfer Tax and Estate Duty) applied. Where a surviving spouse dies on or after 9 October 2007 and their spouse died before the introduction of the current inheritance tax provisions, a claim may still be made for the nil rate band of the surviving spouse to be increased by reference to unused allowances of their spouse. **This is explained further on page 2.**
- Transfers between UK domiciled spouses are totally exempt (this is not the case with non-domiciled spouses where specialist advice should be taken).
- There is a nil rate band (not an exemption but an allowance) whereby the first £325,000 (currently), is taxed at zero percent.
- Each individual has an annual allowance of £3,000, enabling them to make gifts each tax year. If the previous year's gift allowance has not been used it may be carried forward and used after the current year's allowance has been utilised. Thus it can be possible to gift £6,000 every other year. The annual allowance can be given as several smaller gifts to a number of individuals or simply as one gift up to £3000 to one individual. Where several transfers are made on the same day, the annual exemption is pro-rated based on the value of each transfer.
- Small gift allowance of £250, which can be made to as many individuals as is required, but cannot be added to the annual gift allowance (i.e. one individual can not be gifted £3,000 + £250 in one tax year and have it all treated as exempt).
- Gifts on consideration of marriage are exempt up to the following limits:
 - £5,000 to one's children
 - £2,500 to one's grandchildren
 - £1,000 to anyone else.

These can be made on top of the annual allowance.

- Gifts from normal expenditure can be exempt provided they are from income and do not materially affect the standard of living of the person making the gift. There is no limit to the amount that can be exempt under this rule, however gifts must be shown to be both 'regular' and 'habitual' which restrains many opportunities for using this exemption.
- Gifts to charities and political parties are exempt.

Please note that for a gift to be considered exempt the donor must not retain an interest in it. Thus gifting your house to your children may result in you no longer legally owning it but for IHT purposes, it is still part of your estate whilst you live in it. Such a gift is likely to be valued at more than the available exemptions or allowances.

Therefore, to be effective, gifts have to be made without reservation of interest. The value of the gift is considered to be the amount of loss to the estate rather than the intrinsic value of the gift.

For example gifting one of a set of six antique dining chairs will diminish the value of the estate by more than the value of one chair, as a set of six will be more valuable than 5/6.

Gifts above the exempt limit may be either **Potentially Exempt Transfers (PETs)** or **Chargeable Lifetime Transfers (CLTs)**. There is a significant difference in the way these are taxed.

Chargeable Lifetime Transfers are usually created when a gift is made into a trust, unless the gift is covered by a relief or exemption. Notable exceptions to this general rule are for gifts into bare trusts (where the beneficiary is aged 18+) and trusts for the vulnerable and disabled. Because of the nature of the trust, there are no immediate beneficiaries on whose death further IHT may be calculated, so the use of such trusts appears to be highly effective at removing assets from the estate of several generations.

Because of this, such transfers are taxable at the lifetime rate of 20% at the time of making the gift (only amounts above the nil rate band will be so taxed). If the donor dies within seven years of making the gift the balance of the 40% tax due will be collected less any taper relief.

Potentially Exempt Transfers are transfers of assets in excess of the allowances but which are not Chargeable Lifetime Transfers. There is no tax payable at the time of making the gift and if the donor lives for seven years from the time of making the gift, the gift becomes exempt.

Both PETs and CLTs benefit from taper relief. Taper relief reduces the amount of tax payable on death from the full rate of 40% on a sliding scale over seven years. No tax is payable from the beginning of the eighth year after making the gift.

Taper relief is widely misunderstood. It relates to a reduction in the level of tax payable on the estate and does not reduce the value of the chargeable estate.

Whilst it is technically correct to say that taper relief will be applied to all gifts made, the effect of taper relief will only benefit gifts of a size sufficient to exceed the nil rate band.

Any gift or series of gifts below this figure would be subject to a tax rate of zero percent.

The 2007 Pre Budget Report introduced with immediate effect the concept of a “transferable nil rate band”; strictly speaking - the transfer of the unused proportion of the nil rate band of the first of a married couple or civil partners to die and the application of that unused proportion to the nil rate band in force on the death of the survivor. The executors for the estate of the surviving spouse may therefore have use of a combined nil rate band up to a maximum figure of £650,000 (2011/12).

An example

On the first death in October 2007 all assets pass to a surviving spouse – no Inheritance Tax is payable due to the spouse exemption but the nil rate band (£300,000 in 2007/08) is unused.

Let's assume the surviving spouse dies at some future point when the nil rate band stands at £350,000. Since the first spouse failed to use 100% of his/her allowance, the corresponding percentage may be applied to the nil rate band 'in force' at time of second death.

The survivor's estate will then enjoy use of a 'doubled' nil rate band of £700,000. In order to consider use of the first nil rate band the surviving spouse must have been alive on 9th October 2007 - the date of the Pre Budget speech. Whilst there is no time limit for the purposes of reassessing the wasted nil rate band, other factors such as the legislation in force at the time and historic gifts made in the years prior to first death may impact upon its availability.

In addition, despite the undoubtedly helpful introduction of the transferable nil rate band, there will nevertheless remain, under certain circumstances, valid reasons for both Will Trust and lifetime based inheritance tax planning.

The above is a brief summary of the main features of inheritance tax and there are a number of ways that inheritance tax can be mitigated considerably. Gordon Tate Associates have a wealth of experience in this field and will be happy to help you choose the best ways for you to retain your wealth for your family to benefit rather than the taxman.

For further information or to book an initial consultation, please call us on 0845 0138659.

Gordon Tate Associates is a trading name of Honister Partners Ltd. Honister Partners Ltd is an appointed representative of Sage Financial Services Ltd, which is authorised and regulated by the Financial Services Authority.

Information given in this article is for guidance only and should not be taken as individual advice. We cannot assume legal liability for any errors or omissions it might contain. Specific advice should be taken before acting on any of the guidance set out in this article.

Gordon Tate Associates

Address: Rosemount House, Rosemount Avenue, West Byfleet, Surrey, KT14 6LB

Email: gordon@gordontate.co.uk

Tel: 0845 013 8659

Mob: 07973713194