ACTION POINTS

Write a will
You can use it to reduce inheritance tax on your estate.

Give away assets while you're alive
Gifts to individuals made more than seven years before your death are free of IHT.

Make use of tax-exempt gifts
You can, for example, give up to £3,000 tax-free each tax year (see p54 for more)

Play safe
You should never put your own or your partner's income or lifestyle at risk simply to save on having to pay inheritance tax.

Inheritance tax

Rising house prices mean inheritance tax is no longer just a tax on the seriously well off. But there are things you can do to keep your bill down

Put simply, inheritance tax (IHT) is a tax that is charged on the value of your estate when you die. Revenue & Customs takes a percentage, at the rate that applies at the time, of anything over a tax-free limit. However, some gifts you make on death don't attract IHT – see p54.

But it isn't just what you leave behind that may attract IHT. Gifts that you make while you are alive may also be subject to IHT. Again, some lifetime gifts don't attract IHT and others qualify for a reduced tax bill – see p54.

HOW MUCH IS PAID

For 2006-2007 the tax-free threshold is £285,000, and the rate the excess is taxed at is 40 per cent. So using 2006-2007 figures, on an estate worth £500,000, the total inheritance tax bill would come to £86,000 (40 per cent of the difference between £500,000 and £285,000).

GETTY IMAGES

HOW TO WORK OUT YOUR IHT BILL

To value your estate, add up:

- any gifts you made in the last seven years that attract IHT (chargeable lifetime gifts and any potentially exempt transfers – see p54)
- your property (including any abroad), cash, belongings, savings and investments and life insurance paid to your estate on your death (but not any life insurance that pays out under trust to someone else). Include your share of anything you own jointly
- gifts you've made where you've retained some benefit – for example, a house you have given to someone but still live in (see 'Gifts with reservation', p55)
- assets held in certain types of trust from which you get some benefit – an income, say.

After that, subtract the value of:

- your debts (such as a mortgage) and reasonable funeral expenses
- gifts made on death that are exempt from inheritance tax (see p54).

If the total is below the tax-free threshold limit, there is no IHT to pay. If it is above, the excess is taxed at the rate applicable when you die.

WHO PAYS IHT

In some cases, inheritance tax is paid from your estate. But where it becomes due because you die within seven years of making a gift, payment falls initially to the recipients. If they cannot or will not pay, the amount comes out of your estate.

TIP

Same-sex couples who form civil partnerships are treated as married for inheritance tax and intestacy, so where we use 'married' in this chapter we are also referring to civil partners.

TAX ON GIFTS

How inheritance tax is applied to gifts you make on your death or during your lifetime

Gifts are taxed differently depending on when you make them; some gifts escape inheritance tax altogether.

TAPER RELIEF AT A GLANCE

Time from gift to death	Reduction in tax payable on gift (%)	Effective rate of tax (%)
0 to 3 years	Nil	40
3 to 4 years	20	32
4 to 5 years	40	24
5 to 6 years	60	16
6 to 7 years	80	8

GIFTS ON DEATH

There are essentially three types of gifts, for the purposes of IHT, you can make on death:

- tax-exempt gifts – these are never subject to IHT (see 'IHT-exempt gifts at a glance', below)
- gifts that bear their own tax – with these, the amount you give is treated as a gross gift out of which the recipient must pay any tax due
- free-of-tax gifts – with these, the recipient gets the amount you specify, and any tax due is paid from the residue of your estate (the amount left after all the specific gifts in your will have been paid). The residue can itself be either tax-exempt (if, for example, you pass it to your husband or wife) or bear its own tax. If you give away a lot of free-of-tax gifts, the residue could end up being very small once tax has been paid. In general, a specific gift mentioned in your will is treated as a free-of-tax gift unless you have indicated otherwise, so to avoid confusion, make your wishes clear in your will.

GIFTS IN YOUR LIFETIME

There are some gifts that you can make while you are alive that are free of IHT – see 'Gifts made during your lifetime', in the box below.

Potentially exempt transfers

Most gifts made in your lifetime, other than those that are tax-free, are treated as potentially exempt transfers (Pets). These gifts are exempt from IHT unless you die within seven years of making them, when they become taxable. This rule is in place to stop people avoiding IHT by giving away all their assets just before they die.

Warning

Even though you may not have to pay IHT on lifetime gifts, you may have to pay capital gains tax if the gift is an asset, not cash (see p49).

When you die, all Pets you've made in the last seven years of your life are added together to work out whether IHT is payable on your estate (immediately chargeable gifts made in the seven years are also included – see 'Taxable lifetime gifts', p55). If the total is:

- over the tax-free threshold, there will be IHT to pay on any part of your estate that isn't IHT-exempt
- less than the tax-free threshold, the unused part of the threshold can be set against your estate so there will be tax to pay on only the part that isn't IHT-exempt
- still below the tax-free threshold when added to your assets at death, there will be no IHT to pay.

The Pets will be reassessed separately to see whether any tax is due on them at the time of death. For each Pet, this involves adding together any chargeable gifts during the seven years up to the date the Pet was made. If the running total, including the PET, exceeds the IHT threshold (using the rate at the time of death), tax will be due on all or part of the Pet. If the recipient doesn't pay the inheritance tax due, the money comes out of your estate. See 'The effect of Pets on IHT', right, for a worked example.

If, when you die, IHT becomes due on a Pet or taxable lifetime gift, taper relief reduces the IHT on any gifts you make between three and seven years before your death. 'Taper relief at a glance', above, shows how taper relief reduces the amount of IHT.

IHT-EXEMPT GIFTS AT A GLANCE

The following gifts are not subject to inheritance tax

Gifts made during lifetime or on death

- Gifts between a husband and wife or civil partners who are both domiciled (broadly, have their permanent home) in the UK. Where the patry making the transfer is domiciled in the UK and the recipient is domiciled abroad, only gifts up to £55,000 are exempt.
- Gifts to UK-established charities, national museums, universities, the National Trust and certain other bodies.
- Gifts to political parties (broadly, those represented in parliament).
- Gifts to registered housing associations and community amateur sports clubs.

Gifts made during your lifetime

- Most gifts made more than seven years before your death.
- Gifts to people getting married – up to: £5,000 from each parent of the couple; £2,500 from each grandparent or remoter relative; £2,500 from bridegroom to bride (and vice versa); £1,000 from anyone else.
- Any number of gifts worth up to £250 in total a year to each recipient (but see below).
- Gifts of any amount out of your income and part of your normal expenditure, as long as they don't reduce your standard of living.
- Gifts for maintenance of husband or wife, ex-husband or ex-wife, relatives dependent on you through old age or infirmity.
- Gifts for the maintenance, education or training of your children (including step- and adopted children) in full-time education or aged 18 or under.

You can in addition make IHT-free gifts of up to £3,000 in total in each tax year – but you cannot combine these with a £250 gift to the same person. Husbands and wives each have a £3,000 limit and can carry any unused part forward one year only, to the next tax year.

£ SAVING ON YOUR IHT BILL

The following action may reduce or even eliminate a potential IHT bill

Here are some things you can do to reduce the amount of IHT that becomes payable when you die. While it's worth considering these, never jeopardise your own or your partner's income or lifestyle simply to save tax that someone else will pay.

USE YOUR WILL

Most married couples leave everything to each other in their wills, effectively halving the amount they could leave that would be free of IHT. When the first partner dies, everything passes tax-free to the surviving partner (there's no IHT on gifts between married couples). But this person's tax-free allowance is lost forever and, when they die, IHT is payable on everything over the limit.

By writing your wills so that you both leave some of your estate to your children, you can make use of both allowances and reduce or eliminate the tax bill.

If leaving money to your children like this potentially causes financial problems for the surviving partner, consider a discretionary will trust. With this, you place an amount up to the IHT allowance in a trust, with your partner and children as trustees. The trustees have a discretion as to what to do with the income and capital (it could involve paying amounts to your partner when needed). Whatever is left passes to your children on your partner's death.

TAKE OUT LIFE INSURANCE

You can take out a life insurance policy to cover any IHT liability (your insurance company can provide the forms). But make sure you put the policy into trust for the person who will benefit – that way, the proceeds don't become part of your estate and are therefore free of IHT.

START MAKING GIFTS EARLY

You can reduce the value of your estate on death by making lifetime gifts. And most other gifts will be free of IHT if you survive seven years after making them. See 'IHT-exempt gifts at a glance', opposite.

You'll save most tax by giving away those assets which you expect to increase most in value.

Taxable lifetime gifts

If you make a gift during your lifetime to a company or trustees of a discretionary trust (one where no specific beneficiary has a right to income), and to most other trusts set up from April 2006, you may have to pay IHT at the time you make it.

If at the time of the gift, your running total of lifetime gifts over the last seven years exceeds the IHT threshold, you'll be charged at half the rate charged on death (currently at 20 per cent). If you die within seven years, the tax status of the gift is reassessed at the death rate applicable at the time of death, and extra tax may become payable.

GIFTS WITH RESERVATION

If you give something away but continue to benefit from it, the gift remains part of your estate, so the value of your estate isn't reduced for IHT. Such gifts are known as gifts with reservation (GWR), and the rule applies to gifts made on or after 18 March 1986.

Examples of gifts with reservation include:

- giving your home to your children but continuing to live there yourself
- giving away a lump sum in a bank account but continuing to get the interest from it
- giving away a painting that continues to hang in your home.

Various schemes have been marketed to get round the GWR rules. But you'll be caught by the 'pre-owned assets' rules instead, which means you're likely to have to pay income tax. You can avoid this by choosing to have the gift treated as a GWR, when it once again becomes subject to IHT, by paying the market rent for the occupation or use of a property, or by reversing the IHT-saving scheme. But it is important that you get advice from a qualified tax adviser.

GIVING AWAY A BUSINESS

Most gifts of business interests qualify for business property relief at up to 100 per cent, provided that the business is not wholly or mainly an investment business and has been owned for at least two years. So in most cases, no IHT (or a reduced amount) is payable. Agricultural property relief applies to gifts of farms and the like – here the required period of ownership is either two or seven years. ▶

THE EFFECT OF PETs ON IHT

A man gives each of his five children a gift of £15,000 every year from 1999 to 2003. He dies on 30 April 2006. This is how the gifts are treated for IHT, assuming he's used his £3,000 gift exemption each year and no gifts qualified for any other exemptions.

Date of gift	Running total	Tax payable	Reason
25 Dec 1999	£75,000	Nil	Gift within tax-free slice of £285,000
25 Dec 2000	£150,000	Nil	Gift within tax-free slice of £285,000
25 Dec 2001	£225,000	Nil	Gift within tax-free slice of £285,000
25 Dec 2002	£300,000	£4,800	£60,000 is within £285,000 tax-free slice. The remaining £15,000 is subject to IHT at 40% (meaning tax of £6,000). However, the IHT is reduced by 20 per cent (see 'Taper relief at a glance', p54). This leaves £4,800 payable
25 Dec 2003	£375,000	£30,000	All the gift is subject to IHT with no reduction. The remaining estate is also subject to IHT at the full 40 per cent, as all the tax-free slice has been used up

INTESTACY RULES: ENGLAND AND WALES

WHERE THE DECEASED LEAVES...

A spouse but no children

Surviving spouse gets 'personal chattels', currently the first £200,000 plus half remaining estate. The rest goes to the deceased's parents. If none survives, the estate goes to siblings (or their children). If none survives, the spouse inherits the estate

A spouse and children

The spouse gets 'personal chattels', currently the first £125,000 plus a life interest on half the remainder (which passes on death to the children). The children inherit the rest

No spouse and children

The estate is divided equally between the children

No spouse or children

The estate goes to the deceased's parents. If neither is living, it passes to relatives, in the following order:

- brothers/sisters (or their children if the parent has died)
- grandparents
- uncles/aunts (or their children if the parent has died)

No near relatives

The estate goes to the crown

Note Where the beneficiaries are minors, the assets are held in trust until they reach 18 or they marry (or form a civil partnership), whichever is earlier. If someone who is due to inherit dies before the deceased, any children they have inherit their share. 'Children' includes illegitimate and adopted but not step-children; 'spouse' includes civil partners. A life interest is one where the beneficiary has a right to income but not the capital.

MAKING A WILL

The only way to ensure those you want to inherit do so is by making a will

Every adult should make a will. If you don't, you die intestate, and this can mean that the people you want to inherit from you might not get a penny. See the chart above for how the intestacy rules work in England and Wales.

NORTHERN IRELAND

The rules are similar to those for England and Wales, except where there is a surviving spouse and children. The surviving spouse gets the personal chattels (furniture and jewellery, say) plus currently the first £125,000 of the estate. They then get a varying proportion of what's left depending on the number of children. The spouse gets total control of this proportion, not just a life interest.

SCOTLAND

In broad terms, the law provides first for the surviving spouse through 'prior rights' to the family home, its furnishings and a cash sum. After this, there are the 'legal rights' of the surviving spouse and children. Close relatives get whatever's left.

MORE HELP

HMRC leaflets and booklets

- HMRC Capital Taxes: Customer guide to Inheritance Tax (online)
- IR45 What to do when someone dies – a guide for personal representatives.
- IHT2 Inheritance tax on lifetime gifts
- IHT3 Inheritance tax- an introduction
- IHT8 Alterations to an inheritance following a death
- IHT14 Inheritance tax – the personal representatives' responsibilities
- IHT15 Inheritance tax – how to calculate the liability
- IHT18 Inheritance tax – foreign aspects