INHERITANCE TAX

A large percentage of the value of your estate may have to be handed over to the Revenue when you die. But plan carefully and the tax bill can be reduced

When you die, your beneficiaries may have to pay inheritance tax on your estate. But inheritance tax doesn't apply only after death. It may also be levied on certain gifts you make during your life. Inheritance tax becomes due if the value exceeds a threshold set by the Inland Revenue. Below this threshold, there is no tax to pay. This tax-free threshold (known as the nil-rate band) is £272,000 for the 2005-2006 tax year (£263,000 in 2004-2005). Realistically, this means that, if you own even a comparatively modest house these days, there may be inheritance tax to pay.

Planning ahead can reduce the tax bill, or eliminate it – we give some tips in this chapter. And, on p66, we answer some common questions about inheritance tax.

TAX ON GIFTS

Inheritance tax (IHT) is charged on the running total of all gifts (including property) that you make over seven years. But some gifts are free of IHT on death or during your lifetime or both. Others – called potentially exempt transfers – are taxed only if you die within seven years of making them. Bear in mind that, even though IHT may not apply, you may have to pay capital gains tax if the gift is an asset rather than cash (see p52 for more on capital gains tax).

IHT-exempt gifts during your lifetime

The following gifts are always free of IHT.

- Gifts to people getting married, with a maximum value of £5,000 from each parent of the couple, £2,500 from each grandparent and from one of the parties to the marriage to the other, and £1,000 from anyone else.
- Any number of gifts worth up to £250 in total a year to each recipient (but see below).
- Gifts up to any amount that are out of your income and part of your normal expenditure, provided they don't reduce your standard of living (such as premiums on a life insurance policy for someone else's benefit).
- Gifts of reasonable amounts to support a dependent relative.
- Gifts for the education, training or maintenance of your children if they are still in full-time education or training, 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 with a £250 gift to the same person. Husbands and wives each have their own £3,000

GIVING AWAY A BUSINESS

Most gifts of business interests qualify for business property relief from IHT at up to 100 per cent, provided the business owned is not wholly or mainly an investment business. So, in most cases, no IHT (or a reduced amount) will be payable. A similar relief (agricultural property relief) applies to gifts of farms and similar assets.

Gifts between spouses are free of IHT if both live in the UK

limit and, if you don't use up the limit, you can carry the unused part forward, one year only, to the next tax year and give up to £6,000.

IHT-exempt during lifetime or on death
The following gifts are always free of IHT.

- Gifts between a husband and wife who are both domiciled in the UK, or who are both domiciled outside the UK at the time the gift is made. If just your spouse is domiciled overseas, only gifts up to £55,000 are exempt over a seven-year period.
- Gifts to UK-established charities, UK national art galleries, universities, local authorities and other similar bodies.
- Gifts of UK land to registered housing associations.
- Gifts to political parties represented in Parliament provided the political party has two MPs or has one MP but received 150,000 or more votes.

TAXABLE LIFETIME GIFTS

There are some cases where you may have to pay IHT even when you make a gift during your life (but only if your running total at the time of the gift exceeds the tax-free slice). This applies mainly to gifts to companies and to the trustees of certain types of trust where no specific beneficiary has a right to income. Such trusts are known as discretionary trusts. Any IHT due is charged initially at half the rate charged at death (so currently at 20 per cent). If you die within seven years of making the gift, the tax status of the gift is reassessed at the death rate (currently 40 per cent). As a result, extra tax may become payable.

POTENTIALLY EXEMPT TRANSFERS

Most gifts or transfers made during your lifetime, other than those already mentioned, are treated as potentially exempt transfers (Pets). These gifts are exempt from IHT unless you die within seven years of making them, in which case they become taxable. This rule is in place to stop people avoiding IHT by giving away all their assets shortly before their death.

If a Pet becomes taxable, IHT is charged at the rate applicable at death (0 per cent on the nil-rate band and, currently, 40 per cent on anything more). However, the amount may be reduced by taper relief – see the 'Taper relief' table, below.

TAPER RELIEF

Taper relief reduces the IHT on any gifts made between three and seven years before death. However, because of the way IHT rules are applied, often gifts that would qualify for this relief escape tax completely. This is due to the fact that, when you die, all gifts made in the previous seven years and any taxable lifetime gifts are applied against your tax-free slice first before the rest of your estate. As a result, some or all of your tax-free slice is used up, leaving little or no room for the rest of the estate – see 'The effect of taper relief on IHT', below.

TAPER RELIEF

Time from gift to death	Reduction in tax payable on gift (%)
0 to 3 years	Nil
3 to 4 years	20
4 to 5 years	40
5 to 6 years	60
6 to 7 years	80

THE EFFECT OF TAPER RELIEF ON IHT

A man gives each of his five children a gift of £15,000 every year from 1998 to 2002. He dies on 30 April 2005. This is how the gifts are treated for IHT, assuming he's used his £3,000 gift exemption each year, and that no gifts qualified for any other exemptions.

Date of gift	Running total	Tax payable	Reason
25 Dec 1998	£75,000	Nil	Gift within tax-free slice of £272,000
25 Dec 1999	£150,000	Nil	Gift within tax-free slice of £272,000
25 Dec 2000	£225,000	Nil	Gift within tax-free slice of £272,000
25 Dec 2001	£300,000	£8,960	£47,000 is within £272,000 tax-free slice. The remaining £28,000 is subject to IHT at 40% (meaning tax of £11,200). However, the IHT is reduced by 20 per cent[a] (see the taper relief table, above). This leaves £8,960 payable
25 Dec 2002	£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[a], as all the tax-free slice has been used up

a Rate for 2005-2006 tax year not known at time of going to press. We've assumed it stays as for 2004-2005

GIFTS WITH RESERVATION

When you give something away, your estate normally reduces by the value of the gift, so any IHT liability will be reduced. However, if you give something away in name only but continue to benefit from it, the gift remains part of your estate and doesn't reduce the value of your estate for inheritance tax purposes. This is known as a 'gift with reservation' (GWR). Gifts with reservation apply only to gifts made after 18 March 1986. Examples include:

- giving your home to your children but continuing to live there. To avoid this being treated as a gift with reservation, you must pay your children a market rent or bear your full share of the costs of the home if the children live with you
- 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.

A variety of more complicated schemes have been marketed to get round the GWR rules. These may be effective in saving IHT – but be warned: from 6 April 2005, they are likely to lead to an income tax charge under new 'pre-owned asset' rules. You can only avoid the income tax charge by reversing the IHT-saving scheme or by choosing to have the gift treated as a gift with reservation so it once again becomes subject to IHT.

INTESTACY RULES: ENGLAND AND WALES

WHERE THE DECEASED LEAVES...

A spouse but no children	A spouse and children	No spouse and children	No spouse or children	No near relatives
Surviving spouse gets 'personal chattels', the first £200,000 plus half the remaining estate. The rest goes to the deceased parents. If none survives, the estate goes to siblings (or their children). If none survives, the spouse inherits the estate	The spouse gets 'personal chattels', the first £125,000 plus a life interest on half the remainder (which passes on death to the children). The children inherit the rest	The estate is divided equally between the children	The estate goes to the deceased's parents. If neither parent 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)	The estate goes to the crown

Note Where the beneficiaries are minors, the assets are held in statutory trusts until they reach 18. If a child dies, any children they have inherit their share. The definition of 'children' includes illegitimate and adopted but not step-children

WHO PAYS IHT

Liability for IHT after your death depends on when the gift is made. If the gift is taxable at the time it's made, either the giver or the recipient can pay. If the giver pays, the total gift is assumed to be the value of the gift plus the tax. If the giver fails to pay the tax, the Revenue may be able to recover it from the recipient.

If inheritance tax becomes due on a lifetime gift because the giver has died within seven years of making it, it is charged initially to the person who received the gift. If they can't, or won't, pay, the amount comes out of the giver's estate.

Liability for IHT after death depends on when a gift is made

For IHT purposes, there are essentially three types of gift you make on death:

- tax-exempt gifts – by definition, these are not subject to IHT
- free-of-tax gifts – with these, the recipient gets the amount you specify and any tax due is paid from the residue of the estate. (If you give away a lot of free-of-tax gifts, the residue could end up being very small once tax has been paid)
- 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.

In general, a specific gift mentioned in your will is treated as a free-of-tax gift unless you've indicated otherwise. To avoid confusion, it's a good idea to make it clear in your will whether you want a gift to be free-of-tax or to bear its own tax.

Whatever is left after you've deducted specific gifts is called the residue. The residue can itself be either be tax-exempt (if, for example, you pass it to your husband or wife) or bear its own tax.

The amount that people receive depends on the mix of gifts that you are making. If your will is complicated, get advice from a solicitor or tax expert. For more see IHT15 *Inheritance tax: how to calculate the liability*.

TAX ON YOUR DEATH

There is no capital gains tax to pay on assets that you leave when you die – the new owners acquire the assets at their value on the date of death. However, depending on how much you leave, your estate may be subject to inheritance tax.

To value your estate, add up:

- any gifts you made in the last seven years that are not exempt from IHT (that is, chargeable lifetime gifts and any Pets you have made)
- your property (include any you own abroad), belongings, cash, savings and investments and life insurance paid to your estate on your death (but not any life insurance paying out under trust to someone else)
- the value of property where you are entitled to the income under the terms of some trusts
- gifts with reservation – see 'Making a will', right.

If the value of your estate is no more than £272,000 in 2005-2006, there's no IHT to pay

After that, subtract:

- gifts in your will that are exempt from inheritance tax (to a surviving spouse, for example)
- your debts (such as a mortgage) and reasonable funeral expenses.

If the value is no more than the tax-free slice (£272,000 for the 2005-2006 tax year), there is no IHT to pay. If it is valued above this, the excess is taxed at 40 per cent.

HOW TO REDUCE IHT

We list here some of the steps you can take to cope with, or reduce, the amount of inheritance tax that becomes payable when you die. While it's certainly worth considering these, bear in mind that you should never put your own or your partner's income or lifestyle at risk simply to save tax that someone else will pay.

Take out insurance

You can reduce or eliminate the effect of inheritance tax by taking out an insurance policy to cover the tax liability. But if you do this, you need to make sure that you put the insurance policy into trust so that the proceeds don't become part of your estate (your insurance company can provide the necessary forms). See 'Whole-of-life insurance', *Which?*, January 2004, p22, and 'How to limit inheritance tax', *Which?*, July 2003, p46, for more information.

You can also take out seven-year reducing term assurance to pay any extra tax that may become due if you die within seven years of making a lifetime gift.

Start making gifts early

Giving away assets during your lifetime, thereby reducing the value of your estate, will reduce your tax bill on death. You can also use your gift allowances to make fully exempt gifts (see 'IHT-exempt gifts during your lifetime', p62). If you can reasonably expect to live for a further seven years after making the gift, your beneficiaries can fully escape tax by your using potentially exempt transfers (see p63). You will save the most tax by giving away those assets which you expect to increase most in value.

Use your will

You can also use a will for tax planning. Each person has a nil-rate band (£272,000 in 2005-2006 tax year), so married couples together have an allowance of £544,000. However, unless this allowance is used, on your death (through your will) or by a deed of variation (see 'Making a will', above), it will be lost as it cannot be transferred to the surviving spouse.

By making some simple adjustments to your will, so that part of your estate passes to your children rather than wholly to your spouse, you can substantially reduce the inheritance tax bill when both you and your spouse have died. In fact, your heirs could end up paying no IHT at all. ■

MAKING A WILL

Every adult should make a will. If you don't, according to the law you die 'intestate', and this can mean that the people you'd want to benefit from your death don't get a penny. See the chart, (opposite), for how the intestacy rules work in England and Wales. Under the Civil Partnership Act 2004, registered same-sex partners will be treated as spouses.

The rules for Northern Ireland are similar to those for England and Wales, except where there is a surviving spouse and children. As with England and Wales, the surviving spouse gets the personal chattels (furniture, jewellery and private cars) plus the first £125,000 of the estate. However, in Northern Ireland, the spouse gets a varying proportion of the remainder depending on the number of children. The spouse then gets total control of this proportion, rather than a life interest.

The rules for Scotland are different – a result of Scotland's separate legal tradition. 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 any children. Any remainder is taken by close relatives.

DEED OF VARIATION

It's best to get your will right in the first place. But adult beneficiaries of a will or an intestacy (or the personal representatives of the person who has died) may be able to change the will after you have died (to make your will more tax efficient, say). Changing a will in this way is called a deed of variation. Any such change must be done within two years of the deceased's death and all beneficiaries must agree to the changes – including those who lose out.

MORE HELP

Inland Revenue leaflets

- IR45 What to do about tax when someone dies
- 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