Chapter 23

INHERITANCE TAX

1 Introduction

The majority of UK taxpayers will only experience chargeability to Inheritance Tax (IHT) on one occasion – when they die! If their Chargeable Estate exceeds the nil rate band, currently £325,000, the excess will be taxed at 40%.

If only the assets still owned at the time of death were to be taxable, "deathbed gifting", giving assets away just prior to death, would effectively avoid this tax. This means that certain lifetime gifts, those made within 7 years of death, will also become chargeable on the death of the taxpayer. In addition there are also some transfers made in lifetime, transfers into trusts that will generate immediate chargeability to IHT as well as chargeability on death.

2 Transfer of Value

IHT is a cumulative donor based tax and for it to arise an individual must make a transfer of value i.e. a gift, computed as the loss to the estate of the donor. This is calculated as the difference in estate value before and after the gift of the asset.

The amount of tax that may be payable on a transfer of value is based on the cumulative amount of transfers made by the donor over a 7 year period.

For most assets the transfer of value will be the same as the open market value of the asset e.g. gifting a property worth £250,000 or cash of £100,000, but for some assets, notably shares in unquoted companies the transfer of value may be considerably higher than the market value of the asset being gifted.

Illustration 1
A owns 60% of the shares in A Ltd. A Ltd has 100,000 £1 ordinary shares in issue.

Share valuations have been agreed as follows:

20%	£10 per share
40%	£15 per share
60%	£25 per share
80%	£40 per share

Compute the transfer of value if A were to die leaving his shares to his daughter, or alternatively if he were to make a lifetime gift of 20,000 shares to his daughter.

If A died owning his 60,000 shares, a 60% shareholding, they would be valued at £25 per share i.e. 60,000 @ £25 = £1,500,000.

If, however, he were to give 20,000 shares in lifetime the transfer of value would not be based on the value of a 20% interest i.e. £10 per share, but would be computed as the difference between the value of his estate before and after the transfer:

Before	60,000 shares (60%) @ £25 =	1,500,000
After	40,000 shares (40%) @ £15 =	600,000
Transfer of Value		900,000

A transfer of value will arise by the gift of an asset either in lifetime and / or on death. For most taxpayers, as stated above, their only transfers of value will arise as a result of their death.

3 The Death Estate

On death the assets owned by the deceased are valued and included in the death estate. If the deceased was UK domiciled, all assets owned are included in the death estate. If non UK domiciled, only assets situated in the UK are included.

If a property held in the estate is mortgaged, the mortgage will reduce the property value if it is a repayment or interest only mortgage. Endowment mortgages are not deducted as they are repaid on death by the life assurance part of that mortgage. The estate should also include the proceeds of any separate life assurance policy on the deceased's life, not the market value of the policy at the date of death.

The value of the estate will be reduced by any legally enforceable debts due at that date e.g. credit card bills, plus funeral expenses and by exempt bequests.

Bequests are exempt IHT if made to:

- Spouse / Civil Partner

The "available" nil rate band is deducted from the value of the chargeable estate. The nil rate band is £325,000 in 2014/15.

The "available" nil rate band is the £325,000 reduced by the value of any lifetime chargeable transfers made by the deceased in the 7 years before death. The balance of the estate is then taxed at 40%.

This IHT liability has to be paid by the Personal Representatives before they get letters of probate allowing the estate to be distributed, but is anyway due 6 months after the end of the month in which the taxpayer died. The IHT is suffered by the beneficiaries, usually the residuary legatee of the estate – the person receiving the balance of the estate after any specific legacies have been paid out.

Illustration 2

Dee Parted, a spinster (never married), died on 1st February, 2015 leaving an estate valued at £0..75M. She had made no chargeable transfers of value in her lifetime and now bequeathed her estate to be split equally between her nieces and nephews.

Compute the IHT liability arising as a result of Dee's death and state the date by which the liability should be paid.

Dee Parted

Chargeable Estate at Death – February 1, 2015	*£'000*
Net Assets	750
Chargeable Estate	750

IHT

325,000 @ Nil	= Nil
425,000 @ 40%	= 170,000
750,000	

The Personal Representatives will be required to pay the IHT liability of £170,000 by 31 August 2015. The tax will come out of the estate and hence is borne by the nieces and nephews.

Illustration 3

As in Illustration 2 but Dee had made a lifetime chargeable transfer of value of £200,000 in June 2012.

Compute the IHT liability arising as a result of Dee's death

As the chargeable transfer made in lifetime falls within the 7 years before the date of death it will become chargeable as a result of Dee's death. It will however fall within the nil rate band of £325,000 in force at the date of death so no IHT will be payable thereon. This will however mean that only £125,000 of nil rate band will now be available in taxing the estate at death. The IHT payable on the Chargeable Estate at Death will now be computed as follows:

IHT

125,000 @ Nil	= Nil
625,000 @ 40%	= 250,000
750,000	

Illustration 4
If in the above Illustration 2, Dee was a widow and had received all of her husband's estate on his earlier death the husband would have made no chargeable transfers as transfers between spouses are exempt. This would mean that 100% of his nil rate band would have been unused. As Dee has then died, a claim may be made for the unused proportion (100%) of the husband's nil rate band to transfer to Dee. Thus Dee's nil rate band will now be:

£325,000 + (100% x £325,000) = £650,000
This will therefore allow an additionalamount of tax of £130,000 (40% x £325,000) to be saved.
Note that irrespective of the level of nil rate band that existed at the date of her husband's death, Dee will now benefit from an extra 100% of the available nil rate band when she dies.

Lifetime transfers are either Exempt Transfers (as noted above), Potentially Exempt Transfers (PET) or Chargeable Lifetime Transfers (CLT).

4 Potentially Exempt Transfers (PET)

A PET is a lifetime gift made by an individual to another individual.

With a PET, the original assumption is that the gift will be exempt IHT. There is therefore no IHT liability at the date of the gift.

If the donor survives more than 7 years from making the gift, the PET becomes fully exempt and is ignored for IHT purposes (though it may still use up annual exemptions (see later note)).

If the donor dies within 7 years of making the gift, it becomes chargeable on the death of the donor. IHT is then payable at 40% on the value of the gift (less any available nil rate band). If the taxpayer did survive for at least 3 years, however from the date of the gift, any IHT charge is reduced by the available taper relief (see note 5 below). Any IHT payable on the PET is paid by the donee.

Where more than one PET has occurred within the 7 years before death the nil rate band is applied strictly on a chronological basis – the earlier transfers benefit first from the nil rate band!

Illustration 5
As in Illustration 3 but Dee had made 2 chargeable transfers in lifetime of £200,000 each, the first in June 2012 and the second in August 2012.

Compute the IHT liabilities arising as a result of Dee's death.

As Dee has made PET's within 7 years of the date of death these now become chargeable along with the Chargeable Estate and the IHT may be computed as follows:

Lifetime Transfers Chargeable on Death

		Gross Transfers	*IHT*
June 2012	PET	200,000	nil
August 2012	PET	200,000	30,000
125,000 @ Nil	= Nil	400,000	
75,000 @ 40%	= 30,000		
200,000			

The £30,000 liability will be paid by the donee of the gift.

As the Nil rate band has been fully used on the lifetime transfers the entire chargeable estate of £750,000 will be taxed at 40% giving a further liability of £300,000 to be paid by the Personal Representatives.

It can be seen therefore that if the taxpayer survives for more than 7 years from the date of the PET it will be both exempt in its own right and in addition will have no effect on the chargeability of either those lifetime transfers falling within the 7 years before death or on the chargeable estate itself.

Illustration 6
If in Illustration 3 and 5 there had been an earlier PET of £200,000 8 years before the date of death, this would be exempt and would have no effect on the amount of IHT payable.

5 Taper Relief

If a taxpayer does not survive for 7 years following the PET but does survive for at least 3 years any IHT payable on the transfer is reduced by taper relief. The relief is applied to the tax charge as follows:

Time from transfer to date of death	Relief
3 – 4 years	20%
4 – 5 years	40%
5 – 6 years	60%
6 – 7 years	80%

(This table is provided in the examination)

Illustration 7
As in Illustration 5 but the 2 lifetime transfers of £200,000 occurred in January 2009 and June 2011 respectively.

Compute the amount of IHT payable as a result of Dee's death.

Lifetime Transfers Chargeable on Death

			Gross Transfers	*IHT*
January 2009		PET	200,000	nil
June 2011		PET	200,000	30,000
125,000	@ Nil	= Nil	400,000	
75,000	@ 40%	= 30,000		

As the PET falls between 3-4 years from the date of death
The tax charge may be reduced by taper relief of 20%

Less; Taper Relief (20%)	(6,000)
	24,000

As in Illustration 5 the nil rate band has been fully utilised on the lifetime transfers made in the 7 years before death so the entire chargeable estate of £750,000 is taxed at 40% giving an IHT liability of £300,000.

It can now be seen that the amount of tax that arises on either transfers made in lifetime or on death cannot be computed in isolation and is nothing to do with the circumstances of the donee. IHT is a cumulative donor based tax.

6 Chargeable Lifetime Transfers (CLT)

A CLT is a transfer made in lifetime into a trust.

With a CLT, IHT is chargeable at the date of the gift using the nil rate band in force at that date. For transfers made before 2014/15 the relevant nil rate band limit will be provided by the examiner. If IHT is payable it should be paid 6 months after the end of the month in which the transfer was made, but earliest the 30th April following the end of the tax year in which the transfer took place.

For example tax payable on a CLT made in December 2014 will be payable by June 30, 2015, whereas if the CLT was made in June 2014 then the IHT would not be payable until April 30, 2015.

The gross rate of IHT on transfers above the nil rate band is 20% and is applied if the tax is being paid by the donee (i.e. the trustees of the trust).

If the tax is paid by the donor the transfer is said to be a net transfer and the gift has to be "grossed up" as the IHT payable by the donor effectively becomes part of the gift. The simple solution to this problem is to apply a net IHT rate of 25% to any part of the net gift in excess of the available nil rate band at that date. The gross amount of this transfer is then computed by adding the amount of IHT to the net transfer.

Illustration 8
Kay Babb made a chargeable transfer into a trust of £400,000 in June 2010. She has made no previous lifetime transfers. The nil rate band in the 2010/11 tax year was £325,000.

Compute the amount of IHT payable, assuming firstly the trustees paid any IHT due, and then that Kay paid any IHT due.

Lifetime Transfers Chargeable When Made

		£	*Gross Transfers*	*IHT*
CLT		400,000	400,000	15,000
325,000 @ Nil	= Nil			
75,000 @ 20%	= 15,000			

If Kay paid the tax the first £325,000 is still within the nil rate band but the excess £75,000 is now taxed at 25%. This tax is then added to the £400,000 to establish the gross amount of the gift:

	£	*Gross Transfers*	*IHT*
CLT	400,000	418,750	18,750

As a CLT is immediately chargeable to IHT, it goes into the donor's IHT cumulation, using up his nil band for the next 7 years.

If the donor dies within 7 years of a CLT, additional death tax may be due to top up the lifetime tax paid. The IHT liability is calculated in the same way as the tax on a PET, with credit given for taper relief and then any lifetime tax paid.

Illustration 9
Having made the chargeable transfer of £400,000 into the trust in June 2010 Kay then died in December 2014 leaving a chargeable estate of £1M.

Compute the IHT payable as a result of Kay's death. Assume that the trustees paid the tax payable in lifetime as shown in Illustration 8.
Lifetime Transfers Chargeable on Death

		Gross Transfers	*IHT*
June 2010	CLT	400,000	30,000
325,000 @ Nil	= Nil		
75,000 @ 40%	= 30,000		

(The tax charge is now reduced by any available taper relief as with PET's but also by any lifetime tax that was paid)

Less:	Taper Relief (40%) (4-5 years)	(12,000)
		18,000
Less:	Lifetime Tax Paid	(15,000)
Additional Tax Due on Death		3,000

If the lifetime tax paid exceeded the amount of tax now due, no additional tax would be payable, but equally there would be no repayment of lifetime tax paid.

7 Lifetime Exemptions

The following exemptions are available against lifetime gifts

- Annual exemption (AE). The first £3,000 of gift each tax year is exempt. Any unused AE is carried forward a maximum of one tax year for use after that year's own AE The exemption is allocated on a strict chronological basis within the tax year.
- Marriage exemption. A gift in consideration of marriage / civil partnership is exempt up to certain limits. For each of the parents of the bride or groom, the first £5,000 is exempt. For remoter ancestors (e.g. grandparents) and for the parties to the marriage themselves the exemption is £2,500. For others, the exemption is £1,000.

These exemptions, firstly marriage, if available and then annual exemption(s) are deducted from the transfer of value to compute the amount of chargeable transfer.

- Small gifts. Gifts of up to £250 per donee per tax year are exempt. However, if this limit is exceeded, the exemption is lost.
- Gifts for family maintenance. Any gifts made to maintain family members are fully exempt.
- Regular gifts out of income. For this exemption, the donor must show a regular pattern of giving. Also the donor must have enough income left to retain their normal standard of living.

Illustration 10
Compute the Chargeable transfer figure for each of the following lifetime transfers:

1)	7 June 2013	a gift to her daughter of £2,000
2)	12 August 2013	a wedding present to her son of £5,500
3)	19 September 2013	a gift to her husband of £20,000
4)	9 July 2014	a gift to her nephew as a wedding gift of £8,000
5)	25 December 2014	gifts of £200 each to two friends as a Christmas gift
6)	25 March 2015	a gift to a trust of a valuable painting worth £100,000

The gift on 19 September 2013 is exempt as a transfer between spouses and the gifts on 25 December 2014 are exempt as they are covered by the small gifts exemption.

The chargeable transfer figures are then computed as follows:

	7/6/2013	*12/8/2013*	*9/7/2014*	*25/3/2015*
	PET	PET	PET	CLT
Transfer of value	2,000	5,500	8,000	100,000
Less: Exemptions				
AE 2013/14	(2,000)			
Marriage		(5,000)		
AE 2013/14		(500)		
Marriage			(1,000)	
AE 2014/15			(3,000)	
AE 2013/14 (b/f balance unused)			(500)	
Chargeable Transfer	nil	nil	3,500	100,000

Note: although the 2012/13 AE is unused and would be brought forward into the 2013/14 tax year, it may only be used after the 2013/14 AE has itself been fully utilised. The 2013/14 AE is not however fully used and a balance of £500 is carried forward into 2014/15 for use after that year's own AE, while the 2012/13 AE is lost.

8 Approach to Exam Questions

In an examination question the following approach should be adopted:

(1) Compute the chargeable transfer for each lifetime gift (as per illustration 10)

(2) If any CLT's have been made the computation for Lifetime Transfers Chargeable When Made must be prepared (as per illustration 8). To compute any tax payable it must be ascertained who paid the tax, donor or donees, to determine the tax rate to apply above the nil rate band

(3) Any lifetime transfers, CLT's or PET's within the 7 years of death are now included in the computation for Lifetime Transfers Chargeable On Death (as per illustrations 7 and 9).

(4) The Chargeable Estate is now established and the tax thereon computed.

In short exam questions not all of the above steps may be necessary and hence the steps should be applied as applicable to the question set.

It may also be required to state by whom and by when the IHT should be paid.

Example 1

Joe Kerr died on April 1 2015, leaving £250,000 to his wife and the remainder of his estate to his son.

At the date of his death Joe owned the following assets:

(1) His principal private residence valued at £300,000 upon which the outstanding repayment mortgage at the date of death was £80,000

(2) A holiday home valued at £140,000

(3) Bank and Building Society Deposits amounting to £230,000

(4) ISA's with a market value of £50,000

(5) 12,000 Shares in Joe Ltd valued at £20 per share

(6) A life assurance policy with an open market value at April 1 2015 of £125,000 from which proceeds of £140,000 were received following Joe's death.

Joe had outstanding credit card bills of £6,000 at the date of his death and had also verbally promised to pay the medical expenses of £1,000 of a friend. Funeral expenses amounted to £6,000.

During his lifetime he had made the following lifetime transfers:

(1) On 20 November 2008 a cash gift of £40,000 to his son on the occasion of his wedding.

(2) On 15 July 2009 he transferred £405,000 into a trust and paid the IHT due thereon

(3) On 8 December 2013 he gave 4,000 shares in Joe Ltd to his son. Prior to the gift Joe owned 16,000 of the 20,000 shares in Joe Ltd. Share valuations agreed with HMRC at this date were as follows:

20% shareholding	-	£8 per share
40% ,,	-	£12 ,,
60% ,,	-	£18 ,,
80% ,,	-	£25 ,,

The nil rate band for the tax year 08/09 was £312,000 and £325,000 for 09/10.

Compute the amount of IHT payable during Joe's lifetime and upon his death.

9 The 7 year cumulation period

In the illustrations so far, apart from illustration 6, all the lifetime transfers, both PET's and CLT's have taken place within the 7 years prior to death and have all therefore been chargeable to IHT on the death of the taxpayer. The earliest / oldest transfers within this period are first to use the nil rate band with the later transfers and / or the chargeable estate at death then being taxed at 40%.

If PET's have been made more than 7 years before the date of death they were neither chargeable when made nor chargeable on death (illustration 6) – they are exempt IHT and are ignored when looking at the 7 year cumulation period used to compute the IHT on transfers that do fall within the 7 years of death and which are therefore chargeable.

The most difficult concept to grasp, however, is how to deal with a CLT made more than 7 years before death. These transfers were chargeable when made using the nil rate band in force at that date but are not chargeable on death as the taxpayer has survived for the required 7 years.

The 7 year cumulation period, however means that when computing the IHT on either a PET or CLT made within the 7 years of death it is necessary to take account of any CLT made within the 7 years prior to it, so as to determine how much nil rate band, if any, remains to use against that transfer.

e.g. If an individual dies in January 2015 having made a CLT in June 2005, this CLT will not be taxable on the death as he survived for more than 7 years. If he had also made a PET in August 2011 this will be taxable. In computing the nil rate band available to go against the PET, however, the £325,000 will be reduced by the amount of the June 2005 CLT as it had been made within the 7 years prior to the PET.

Example 2

Dee Ceased died on 1 March 2015 with a Chargeable Estate of £500,000 having made the following lifetime gifts:

1 October 2002	£100,000 cash to son
1 June 2003	£278,000 cash into a trust
1 September 2009	£296,000 cash to daughter

Required:

(a) Calculate the IHT payable on the lifetime gifts when they were made assuming that Dee paid any lifetime tax due

(b) Calculate the IHT payable as a result of Dee's death.

Nil rate bands are as follows:

02/03	£250,000
03/04	£255,000
09/10	£325,000

10 IHT Planning

As the Chargeable Estate of the taxpayer is charged at 40% above the nil rate band, making lifetime transfers is the easiest way an individual may reduce the IHT liability that would otherwise arise upon his death. This of course assumes that the individual has both the capacity and willingness to make such gifts.

If an individual makes regular lifetime gifts to others out of his income these transfers will be exempt as normal expenditure out of income.

Other gifts to individuals will be PET's:

- these will only become chargeable if the donor dies within 7 years of having made them
- if the individual dies within 7 years the value of the transfer is "frozen" at the time of the transfer. It is therefore beneficial to gift in lifetime those assets that are likely to increase in value over time
- if the donor survives for at least 3 years then any IHT payable thereon is reduced by taper relief

You should now review the following technical article written by the F6 examining team -IHT parts 1 and 2, plus the Finance Act 2014 article - Inheritance Tax section

You may now attempt Practice Question 38