

January 2014

**GUIDE TO INHERITANCE TAX****Introduction**

Inheritance Tax ("IHT") is seen by many as HM Revenue & Customs ("HMRC") having their cake and eating it. Many taxpayers face the prospect on their death of having their assets, acquired in the vast majority of cases with tax funds, taxed again. It is for this reason that a lot of taxpayers spend time and money planning their affairs to reduce the IHT problem on death. Sadly there are many taxpayers who do no planning at all.

This briefing note is intended as an overview of the main IHT provisions.

IHT is a tax on transfers of value by individuals. It may be payable on certain lifetime transfers, on the value of an estate at death, on certain transfers into and out of trusts, and on some transfers made by or to certain categories of company. A transfer will either be a 'chargeable transfer', a potentially exempt transfer ("PET") or exempt. IHT is levied on chargeable transfers.

An asset is valued on the "loss to the donor" principle without reference to the gain for the donee.

IHT is potentially payable on the worldwide assets of individuals domiciled, or deemed to be so, in the UK. Those not domiciled in the UK are only subject to IHT on their UK assets.

The IHT provisions apply equally to civil partners and spouses. This briefing note simply refers to spouses.

**Nil-rate band**

The nil-rate band is the amount that is subject to IHT at 0%. When assessing the amount of the nil-rate band to set against a chargeable transfer the total of all the chargeable transfers in the previous seven years have to be taken in to account.

For the tax year to 5 April 2014, the nil-rate band is £325,000. It has been announced that the nil-rate band will be frozen at that level until 2017/18.

*Transferable nil-rate band*

Where an individual dies, the executors can claim that the deceased's nil-rate band should be increased by the unused portion(s) of the nil-rate band(s) of any spouse(s) who died before the deceased, although the maximum cannot exceed twice the current band.

## Exempt transfers

Where there is a transfer of value, the amount subject to IHT may be reduced in whole or in part as a result of one or more specific exemptions. Deductions are made before considering the nil-rate band availability.

IHT is not applicable where a disposition is for the maintenance of close family or dependants or where there was no gratuitous intent.

There are some specific exemptions for lifetime transfers:

- Annual exemption of £3,000 which if unused can be carried forward to the following year;
- Small gifts;
- Gifts in consideration of marriage; and
- Regular gifts out of income.

Some transfers are exempt whether made during lifetime or by will. The following are examples of such transfers:

- Gifts to charities, housing associations, and for public benefit;
- Gifts to qualifying political parties; and
- Gifts to a spouse (although see below for a restriction to this rule).

## Non-UK domiciled spouse

The exemption for transfers from a UK domiciled (or deemed domiciled) spouse to a non-UK domiciled spouse (who is not deemed UK domiciled) is restricted to £325,000 for transfers after 5 April 2013. However, certain international estate duty treaties override this.

With effect from 6 April 2013 a foreign domiciled spouse is able to make an election to be treated as UK domiciled for IHT purposes. The election enables a foreign domiciled spouse to receive assets of any value from their UK domiciled spouse on death, free of IHT. However this will mean that in future all their worldwide assets will be liable to IHT. So careful consideration is needed before making such an election.

If there is any question as to domicile status, please speak to the tax team at Friend who can guide you.

## PETs

The following lifetime transfers are PETs:

- An absolute gift to another individual;
- A disposition to a qualifying disabled person's trust; and
- A disposition to a bereaved minor's trust on the coming to an end of an immediate post-death interest.

There is no IHT payable when a PET is made but IHT may be payable if the donor dies in the seven years following the PET.

### **Chargeable lifetime transfer ('CLT')**

A CLT is a lifetime gift which is neither exempt nor a PET. A lifetime gift to establish or add property to a trust will generally be a CLT. IHT at the lifetime rate of 20% is due on the value of the transfer in excess of any unutilised nil-rate band.

The IHT can be paid by the donee or the donor. Where the donor pays the IHT the tax payable is also a chargeable transfer meaning that the effective rate of IHT is 25%.

### **Pre-owned asset tax ('POAT')**

POAT is an annual income tax charge which can apply to individuals who are UK resident. It may be triggered where a transaction has been structured so as to allow an individual to benefit from property transferred while avoiding an IHT charge under both normal principles and the gift with reservation of benefit ('GWR') provisions. The rules are complex and specialist advice should be sought.

### **IHT on death**

On death IHT can be charged on:

- Gifts made within seven years of death;
- The value of a person's estate on death; and
- Assets caught by the GWR provisions.

#### *Gifts made within seven years of death*

On death, IHT has to be recalculated on every lifetime transfer made within seven years of death. Once the cumulative transfers exceed the nil-rate band, IHT will be payable at 40% on the excess.

Where the donor has survived for at least three years the rate of tax is reduced on a tapered basis. The reduction increases with the number of years the gift is survived. The donee is responsible for paying any tax triggered by the death.

#### *The estate on death*

The estate on death comprises the net assets of the individual less reasonable funeral expenses, all property to which the deceased had a qualifying interest in possession and non-settled property over which the deceased had a general power of disposal. IHT is charged at 40% on the value of the death estate it has been reduced by appropriate exemptions and reliefs and by the unutilised nil-rate band.

The deceased's personal representatives are responsible for paying the tax. Where relevant, the trustees are responsible for paying any tax due with respect to a qualifying interest in possession of the deceased.

### *Assets caught by the GWR provisions*

Straightforward gifts, where the deceased kept back some benefit, are caught by the GWR provisions. Such gifts are deemed to form part of the donor's estate immediately before their death. The donee is responsible for paying the IHT due.

No charge will arise where full consideration is paid by the donor for any subsequent use of the asset. For example if an individual gives his house to his son, but continues to live in it, neither GWR nor POAT would apply providing the donor pays a full market rent.

### *Reduced rate of IHT*

A reduced IHT of 36% is applied to 'components' of an estate where the relevant charitable legacies exceed 10% of the component(s). This provision applies from 6 April 2012.

### **Limiting the deduction of liabilities for IHT purposes**

Prior to 6 April 2013 liabilities were deducted from the assets against which they were secured for IHT purposes. However new rules set out in Finance Act 2013 mean an outstanding loan is now much more closely tied to the asset that was purchased with the loaned funds. No deduction will be allowed for a liability to the extent that it has been incurred directly or indirectly to acquire property which is excluded from the charge to IHT. Certain loans taken out before 6 April 2013 can continue to qualify for such relief.

A deduction for a liability will only be allowed to the extent that it is repaid to the creditor from the death estate, unless it is shown that there is a commercial reason for not repaying the liability.

If you have any concerns about these provisions please contact the tax team at Friend.

### **Reliefs for assets which qualify as business or agricultural property**

Business Property Relief ('BPR') and Agricultural Property Relief ('APR') may reduce the amount chargeable to IHT by either 100% or 50% depending on the type of asset. APR only covers the property's agricultural value. In contrast, BPR covers the entire value of the property. Eligibility for both reliefs is subject to various conditions such as use of the property, the business activities and length of ownership.

BPR in particular can be a very valuable relief. In many cases taxpayers can reduce the potential impact of IHT by adjusting their investment strategy to encompass investments which may qualify for BPR. As with any investment decision taxpayers must consult with the professionals – never let the "tax tail wag the commercial or investment dog".

The conditions for both reliefs are complicated. Professional advice should be sought before taking any action.

## Payment of IHT

There is a fixed IHT payment deadline of the following 30 April for lifetime transfers made between 6 April and 30 September. IHT for other lifetime transfers is payable six months after the end of the month when the transfer was made. IHT on death is due on the earlier of six months after the end of the month when the death occurred and the delivery of the IHT return. IHT on either a lifetime transfer or on death can be paid in ten annual instalments where the IHT is attributable to land, shares or business assets, the qualifying conditions are met and a claim is made. The outstanding IHT will be payable if the property is disposed of. There is also a specialised IHT payment relief available for qualifying woodlands.

## Planning for IHT

When considering IHT planning there are a number of issues which individuals should consider:

- Lifetime giving and the use of the available exemptions;
- Life assurance cover ensuring that potential policy proceeds are written in trust as with pension lump sums;
- The availability of BPR and APR and whether investment “realignment” could improve the position;
- Ensuring that wills are current and drafted as tax efficiently as possible; and
- Keeping IHT planning in view rather than do it once and then forget about it.

If you have any questions in connection with this briefing please contact Simon Littlejohns, Tax Partner, on 0121 633 2007 or your usual contact at Friend.

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