Inheritance Tax

Inheritance Tax

Introduction

IHT only examinable in the wills' assessment.

Usually a solicitor does the tax calculations for inheritance tax (accountants do income and capital gains tax).

It has not kept pace with inflation, so has in practice become a tax on the middle classes. Levied on wealth at death.

Governed principally by Inheritance Tax Act 1984 (IHTA 1984). Charged on 3 main occasions:

1. Death
2. Lifetime gifts made by individuals within 7 years of death
   - Such gifts known as 'potentially exempt transfers' (PETs)
   - If transferor survives for 7 years, becomes exempt.
   - If transferor dies within 7 years, becomes chargeable.
3. Lifetime gifts to a company or into a trust.
   - Such lifetime gifts are immediately chargeable to IHT at the time when it is made, unless the trust is for a disabled person.

IHT subject to 'general anti-abuse rule' (GAAR) introduced by Finance Act 2013 designed to allow HMRC to counteract abusive tax avoidance schemes.

Calculation

1. Identify the transfer of value
   - Must have been a transfer of value. This is a disposition which reduces the value of the transferor's estate. Basically, there must have been a gift.
   - You are deemed to have made a gift when you die. So death is a deemed transfer of value.
   - Death estate: all the assets to which the deceased was beneficially entitled immediately before death.
2. Find the value transferred.

    - Upon death, value transferred is market value less debts and funeral expenses.
    - For a lifetime transfer, it is the amount of the reduction in the transferor's estate.
3. Apply exemptions and reliefs.
    - Depends on status of person to whom assets are transferred, or nature of assets.
    - Spouse exemption: full exemption between spouses.
    - Charity exemption
    - Business and agricultural property relief
    - Annual exemption
        - £3,000
        - Applies only to lifetime transfers.
4. Calculate tax at appropriate rate
    - Residence nil rate band
        - Must be a "qualifying residential interest"
        - "Closely inherited"–lineal descendants
        - First £175,000 taxed at 0%
        - Only available on death
    - Nil rate band
        - £325,000 taxed at 0%
        - Complicated by cumulation–relates to the nil rate band
        - Can be passed onto spouse/ civil partner.
    - So potentially £1 million exempt.

Chargeable transfers eat up the nil rate band.

Transfers on Death

1. Transfer of Value

The value transferred is the value of the deceased's estate immediately before death.

Estate Defined in s 5(1) IHTA 1984 to mean all the property to which a person was beneficially entitled immediately before their death, with the exception of 'excluded property'. So it includes:

- Property passing under will/ intestacy
    - Deceased "beneficially entitled" to all such property immediately before death.
- Other property to which the deceased was beneficially entitled immediately before their death.
    - Interest in any joint property passing on death by survivorship to surviving joint tenants.
- Property included because of special statutory provisions.
    - Certain trust properties

        * In certain circumstances, a person entitled to the income from a trust is treated for IHT purposes as beneficially entitled to the capital which produces that income.
        * Known as a “qualifying interest in possession”.
        * Interest in possession: fixed trust where beneficiary is entitled to income.
        * An interest in possession arising **before** 22 March 2006 will be a qualifying interest in possession.
        * After this, more limited circumstances: e.g., being an ’immediate post-death interest’
    - Property given away during lifetime ’subject to a reservation’.
        * Applies where deceased gave away property during their lifetime but did not transfer possession and enjoyment of the property to the donee.
        * Donor treated as being beneficially entitled to the property.

But does not include:

- Property outside the estate
    - Life assurance policy once it is written in trust for a named beneficiary.
    - Discretionary lump sum payment made from a pension fund to the deceased’s family.
- Excluded property
    - e.g., ’reversionary interest’: interest in remainder under a trust.

2. Value Transferred

General principle - s 160 IHTA 1984

Assets are valued for IHT pruposes at ’the price which the property might reasonably be expected to fetch if sold on open market’ **immediately before** death.

With assets such as land, may need negotiations with the district valuer to reach an agreed valuation.

Definition

The value of an asset agreed for IHT purposes is known as the **probate value**.

Where death causes the value of an asset to increase or decrease, this will be taken into account (important for e.g., life insurance policies).

Asset	How to value
Quoted Shares	Value taken from Stock Exchange Daily Official List for date of death. Value = bid + $\frac{1}{4}$
Debts and expenses	Debts/ expenses at time of death deductible provided incurred for money/ money's wo

3. Exemptions/ Reliefs

Spouse/ Civil Partner Exemption

s 18 IHTA 1984

A transfer of value is an exempt transfer to the extent that the value transferred is attributable to property which becomes comprised in the estate of the transferor's spouse or civil partner.

The spouse exemption can apply in conjunction with the rule applicable to qualifying interest in possession trusts, that IHT is charged as if the person with the right to income owned the capital. So if a trust is validly created with income for life for a spouse, remainder to children, the whole estate will be spouse exempt on the settlor's death.

Charity Exemption

s 23(1) IHTA 1984

Transfers of value are exempt to the extent that the values transferred by them are attributable to property which is given to charities.

A similar exemption applies to gifts to certain bodies, bodies providing a public benefit, and to political parties.

Business Property Relief Provided that the transferor owned the property/ a replacement property for **2 years** immediately before the transfer, there is a 100% reduction for:

- A business or interest in a business (including partnership share), and
- Company shares not listed on a recognised stock exchange
  - AIM not included in definition of recognised stock exchange.

And a 50% reduction for:

- Quoted shares giving the transferor voting control of the company, and
  - Voting control means the ability to exercise > 50% votes on all resolutions. So this can be denied by *Bushell v Faith* clauses.
  - Separate shareholdings of spouses/ civil partners sometimes taken into account.
- Land, buildings and machinery owned by the transferor personally but used for business purposes by a partnership of which the transferor is a member, or by a company of which the transferor has voting control.

- Note that partnerships treated more favourably than companies here.

Where there is a lifetime transfer followed by the death of the transferor within 7 years, BPR given at the time of the lifetime transfer will be withdrawn unless the transferee still owns the business property at the date of the transferor's death.

Note:

- Transfer need not be of the entire interest/ shareholding.
- Where a person has entered into a contract for sale of their interest in a business, their interest is then taken to be in the proceeds of sale. Cash is not a relevant business property, so no relief available.

Agricultural Property Relief The relief operates to reduce the agricultural value of agricultural property by a certain percentage.

Agricultural value

The value of the property if it were subject to a perpetual covenant prohibiting its use other than for agriculture.

Reduction of 100% is allowed where:

- The transferor had the right to vacant possession immediately before the transfer, or
- Where the property was subject to a letting commencing on/ after 01/09/1995.

Reduction of 50% allowed in other cases.

Must also have been occupied by transferor for 2 years prior to transfer/ owned by them for 7 years prior to transfer and occupied throughout for the purpose of agriculture. Also applies when there is a company structure in the way, of which the transferor had voting control.

Agricultural property relief given in priority to business property relief.

4. Calculate Tax

- 0% on first £325,000
- 40% on anything higher
- If $\geq$ 10% of a defined 'component' of a person's net estate passes to charity, 36% rate applies instead of 40%.

Cumulation Any chargeable transfers made by the transferor over the 7 years before the transfer must be taken into account to determine how much of the nil rate band remains available. Any lifetime exemptions are taken into account.

Not applicable to the residence nil rate band which should be available in full on death, subject to any adjustments for estates over £2 million.

Residence Nil Rate Band

Tax year	Rate
2017/18	£100,000
2018/19	£125,000
2019/20	£150,000
2020/21 onwards	£175,000

Conditions This is available in addition to the nil rate band if the deceased dies owning a 'qualifying residential interest' which is 'closely inherited'.

Qualifying residential interest

An interest in a dwelling house which has at any time been the deceased's residence and which forms part of the deceased's estate.

For a property to be **'closely inherited'**, it must pass to:

1. a child, grandchild or other **lineal descendant** of the deceased outright or on certain types of trust. Lineal descendants are defined as children, step-children, adopted children, foster children, or children where the deceased had been appointed as a guardian;
2. the current spouse or civil partner of the deceased's lineal descendants; or
3. the widow, widower or surviving civil partner of a lineal descendant who predeceased the deceased, unless such persons have remarried or formed a new civil partnership before the deceased's death.

Only applies up to the value of the deceased's residence. If estate worth $\geq$ £$2,000,000$, RNRB reduced by £1 for every £2 over £2 million threshold.

Downsizing Finance Bill 2016 introduced a downsizing allowance; allowing PRs to claim RNRB to which the deceased would have been entitled, had they held onto their property, but instead moved to a care home etc.

Potentially Exempt Transfers (PETs)

PET

Any gift made by an individual to another **individual or into a disabled trust** (IHTA 1984, s 3A(1A)), to the extent in either case that the gift would otherwise be chargeable.

1. Transfer of Value

Transfer of value

Any lifetime disposition made by the transferor which reduces the value of their estate (s 3(1) IHTA 1984)

Some dispositions are excluded:

- Maintenance, education or training of transferor's child under 18/ adult in full time education
- Maintenance of a dependent relative (s 11 IHTA 1984).

2. Value Transferred

Value transferred

The amount by which the value of the transferor's estate is less than it would have been but for the transfer (s 3(1) IHTA 1984).

Recall, the transferor's **estate** is the aggregate of all the property to which they are beneficially entitled.

Related Property Designed to prevent tax avoidance in relation to a group of assets. The value of a single asset within a group of similar assets is the appropriate fraction of the total collection of assets if higher, rather than the value of the single item.

3. Exemptions and Reliefs

A gift is potentially exempt only to the extent that it would otherwise be chargeable.

Standard Exemptions The usual exemptions/ reliefs apply:

- Spouse/ civil partner exemption
- Charity exemption
- Business and agricultural property relief.
  - Only available if transferee still owns the property or qualifying replacement when transferor dies.

Order of application

Apply exemptions and reliefs in the following order:

1. Spouse/ civil partner/ charity exemptions

2. Business/ agricultural property reliefs
3. 'Lifetime only' exemptions

Lifetime Exemptions

IHTA 1984	Exemption	Details
s 19	Annual exemption	The annual exemption applies to the **first** £3,000 transferr
s 20	Small gifts	Lifetime gifts in any tax year of £250 or less to any one pe
s 21	Normal expenditure out of income	Lifetime transfer exempt if: (1) Made out of transferor's no
s 21	Marriage consideration	Lifetime gifts on marriage are exempt up to: £5,000 by a p

Potentially Exempt Any value remaining after exemptions and reliefs applied is potentially exempt. Transfer becomes chargeable only if transferor dies within 7 years.

Lifetime Chargeable Transfers (LCTs)

Note

An LCT is made to a company or trust.

Any lifetime transfer which does not fall within the definition of a PET is an LCT. The aim is to close loopholes involving companies and trusts.

Main examples:

- Lifetime transfer made on or after 22/03/06 into any trust (other than a disabled trust)
- Lifetime trust into a discretionary trust or company.

4. Calculate Tax

First identify transfer of value, calculate value transferred and apply exemptions and reliefs, as set out in (1) to (3) above. Then apply rates:

- 0% on first £325,000 (nil rate band)
- 20% on the balance of the chargeable transfer.

Cumulation

Important

Chargeable transfers made in the 7 years before the current chargeable transfer reduce the nil rate band available to that current transfer.

Note that while the transferor is alive, any PETs made by the transferor are ignored for cumulation purposes because they may never become chargeable.

Effect of Death on Lifetime Transfers

The death of a transferor may result in a charge /additional charge to IHT on any transfers of value which they have made in the 7 years immediately preceding death, whether these were PETs or LCTs.

- PETs made become chargeable and the transferee becomes liable for any IHT payable.
- IHT liability on LCTs is recalculated, and trustees will be liable for any extra tax payable.

Work chronologically forwards over 7 years, calculating appropriate tax.

4. Effect on PETs

Apply steps (1) to (3) to determine size of PET. Then establish the transferor's cumulative total of transfers at the time of the PET. Made up of:

1. Any LCT's made in 7 years before the PET, and
2. Any other PETs made during the 7 years before the PET being assessed.

Rate of tax applicable to **chargeable transfers** made within 7 years of death are:

- 0% on available nil rate band
- 40% on balance (note 36% charity rate not available).
- But subject to tapering relief, see below.

Tip

Draw a timeline.

Tapering Relief When a PET becomes chargeable, tapering relief is available if transferor survives > 3 years after transfer. Any tax payable on PET is reduced.

Years between PET and death	Tax rate
3 to 4 years	32%
4 to 5 years	24%
5 to 6 years	16%
6 to 7 years	8%
7 or more	0%

4. Effect on LCTs

If transferor dies within 7 years of making an LCT, more IHT may be payable, because:

1. Full death rate of IHT now payable
2. PETs made before the LCT may have become chargeable.

A rate of min (rate at death, rate at transfer) is used to calculate IHT. Note this means the inheritance tax rate which happens to be in force at the time of death/ transfer. So for our purposes this will always be 40%.

To determine how much of nil rate band is available, find the cumulative total of:

1. Any other LCTs made in 7 years before LCT
2. Any PETs made during 7 years prior to LCT, which have now become chargeable.

So an LCT within 14 years of death may remain relevant for cumulation purposes.

(TODO: consider adding timeline here)

Tapering Relief If >3 years have passed between transfer and death, tapering relief applies to reduce the recalculated tax. Credit given for IHT paid on LCT at the time, though if the recalculated bill is lower than the original amount paid, no tax is refunded.

Liability and Burden of Payment

Payment will usually be obtained by people holding property in a representative capacity (PRs and trustees), though those who are beneficially entitled to the property are concurrently liable with such representatives.

Estate Rate

Definition

The average rate of tax applicable to each item of property in the estate.

Tax is divided between the various assets in the estate proportionately, according to their value. So multiply the value of the asset by the estate rate to calculate the tax liability of an asset.

Liability on Death

PRs PRs are liable for IHT attributable to the non-settled estate: any property which 'was not immediately before the death comprised in a settlement' (s 200 IHTA 1984). Includes:

- Property vesting in PRs
- Property to which the deceased was beneficially entitled immediately before death.

Note

PR liability limited to the value of assets received/ would have received but for their own negligence or default.

Concurrently liable with the PRs is 'any person in whom property is vested…at any time after
the death or who at any such time is beneficially entitled to an interest in possession in the
property' (IHTA 1984, s 200(1)(c)). But unusual for HMRC to claim tax from the recipient of property.

If a deceased gave away a property during their lifetime but retained a benefit in the property, the donee of the gift is primarily liable to pay tax attributable to the property. If tax remains unpaid 12 months after the end of the month of death, PRs become liable.

Trustees Trustees of settlement liable for IHT attributable to the property.

Liability on PETs

Transferee primarily liable, but PR becomes liable if tax remains unpaid for 12 months after the end of the month of death. PRs should ideally delay distribution of the estate until IHT on lifetime gifts has been paid.

Liability on LCTs

Transferor primarily liable, though HMRC may also claim tax from trustees. In practice, trustees often pay.

If transferor pays, the amount of tax will usually be more than if trustees pay. This is because IHT is charged on the value transferred, i.e., the loss to the transferor's estate brought about by the gift. This is just maths; no more 'efficient' way of doing things.

Burden

The transferor can decide where the burden of tax falls.

Time for Payment

Death Estates

Basic rule: IHT due 6 months after the end of the month of death. If tax not paid on time, interest runs on amount outstanding.

Instalments Instalment option is available

- 10 yearly instalments, first due 6 months after the end of the month of death.
- Tax apportioned using the estate rate
- Applies to:
  - Land
  - Business or interest in business
  - Shares giving control of company to deceased
  - Unquoted shares where holding is sufficiently large (10% nominal value & >£20,000)
  - HMRC thinks lump payment would cause undue hardship
  - IHT payable amounts to $\geq$ 20% IHT payable on estate.
- For anything except non-agricultural land, instalments carry interest only on late payments
- For non-agricultural land, interest payable on the amount outstanding.
- All outstanding tax and interest payable upon sale.

PETs

Due 6 months after the end of the month of death.

LCTs

Timing	Due
At the time of transfer	Generally due 6 months after the end of the month in which LCT made. Bu
Following death within 7 years	6 months after the end of the month of death.