

Outline of Inheritance Tax

Introduction

Inheritance Tax (IHT) was introduced in 1986 to replace Capital Transfer Tax. The main charge to IHT arises on death. IHT is also charged on certain lifetime gifts and on certain events in relation to trusts.

Scope of IHT

If an individual is domiciled in the United Kingdom, IHT applies to all his or her property wherever it is situated. If the individual is domiciled abroad, IHT usually applies only to property situated in the United Kingdom. Special rules extend the meaning of domicile for IHT purposes.

Lifetime Gifts

There are three distinct categories of lifetime gift:

- 1 Exempt transfers are gifts which are wholly exempt from IHT (e.g. gifts between spouses* and gifts within the annual exemption).
- 2 Potentially exempt transfers (PETs) are outright gifts between individuals and, following the 2006 Finance Act, gifts into trusts for the disabled. A PET does not give rise to an immediate charge to IHT. If the donor survives for 7 years, the PET becomes an exempt transfer. If the donor dies within 7 years of the gift, the PET becomes a chargeable transfer: see 3 below.
- 3 Chargeable transfers are gifts made by an individual other than exempt transfers or PETs. This category covers a gift to most types of settlement. If the cumulative total of chargeable transfers

in any 7 year period exceeds the nil rate band threshold, a lifetime transfer is immediately taxable at up to 20%.

In the case of a lifetime gift, the amount on which IHT is charged is measured by the loss to the donor's estate as a result of the gift. This is not necessarily the same as the value received by the donee, or the open market value of the property.

Taper Relief

A gift made within 7 years before death is taxed by reference to its value at the date of the gift.

There is a sliding scale of taper relief which applies in the case of a PET or a chargeable transfer made less than 7 but more than 3 years before death; in such a case the tax charged on death on the PET or chargeable transfer is reduced by 20%, 40%, 60% or 80%, according to whether the death occurs in the fourth, fifth, sixth or seventh years respectively. Since taper relief reduces the tax charged on death and not the value of the gift, the tax on the donor's remaining estate is unaffected and the taper relief will be worthless if the PET or chargeable transfer falls within the donor's nil rate band.

Transfers on Death or Within 7 Years of Death

The charge to IHT on death takes into account the value of the estate on death and also any other property in which the deceased had a beneficial interest, such as settled property in which he or she had a qualifying life interest. Lifetime gifts within 7 years of death must also be taken into account.

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Deeds of Variation

It may be possible for those entitled to a deceased person's estate to sign a Deed of Variation to vary the way in which the estate is distributed. IHT will then be payable as if the revised distribution had operated at death. Further details are available in the information sheet about Deeds of Variation.

Amount and Rates of IHT

Tax is chargeable cumulatively on each chargeable transfer by reference to the total chargeable transfers made within the previous 7 years. This rule applies to transfers which are immediately chargeable, to PETs which become chargeable, and to transfers on death. Thus, a record of gifts made by a donor in the previous 14 years may be needed in order to determine the IHT payable on any one occasion. By way of illustration, to establish the rate of IHT on a lifetime gift in 2011, it may be necessary to aggregate chargeable transfers made in 2004.

No IHT is payable on the first part of the cumulative total, which is taxed at nil%. This nil rate band, or tax-free allowance, is frozen until 5 April 2015. After that date it will be increased each year in line with the increase in the Consumer Prices Index, unless Parliament decides otherwise.

Where the death occurs on or after April 6, 2009 the rates of IHT are as follows:

Cumulative chargeable Transfers	Rate
Up to £325,000	Nil
Excess over £325,000	40%

If a PET becomes chargeable because the donor dies within 7 years, it will become taxable at the death rate then in force. The PET takes its chronological position for cumulation purposes at the time the gift was made at its value at that time. Any tax charge (but not the value transferred) is reduced by taper relief if the death occurs between 3 and 7 years after the gift.

Chargeable lifetime transfers which are not PETs are immediately chargeable to tax at half the death rate being 20%. Additional tax may be due if the donor dies within 7 years after making the transfer.

Gifts With Reservation and Pre-Owned Assets Tax

Gifts made on or after 18 March 1986 are subject to special rules to prevent the avoidance of IHT where the donor reserves or enjoys a benefit from the gifted property. This applies where at any time since the date of the gift the donor has not been entirely excluded from the gifted property and from any benefit by contract or otherwise. An example of such a gift is where a house is given away, but the donor continues to reside in it without paying a full market rent. The result is that, if and so long as a donor reserves a benefit in the gifted property, the 7-year period will not begin to run.

Outline of Inheritance Tax (continued)

An annual tax charge known as the Pre-Owned Assets Tax was introduced from 6 April 2005. It is an Income Tax charge on the benefit of the continuing enjoyment of certain assets given away or paid for since 18 March 1986 in cases where the IHT reservation of benefit rules do not apply. There are various exceptions to this charge. If they do not apply, the charge relates to the continuing occupation of land or use of chattels. There will be an annual Income Tax liability if the person occupying property or using chattels, but not owning them, has since 18 March 1986 either disposed of them or contributed directly or indirectly to their acquisition. The charge can also apply in certain circumstances to other assets (i.e. not land or chattels) if they are held in a trust of which the settlor is an actual or possible beneficiary.

Exemptions

Certain gifts are exempt from IHT. Some of the most important of the exemptions are as follows:

1 Husband and wife

All outright transfers between spouses are completely exempt (unless the donor is domiciled in the United Kingdom but the donee is not).

2 Annual exemption

Lifetime gifts are exempt up to a total of £3,000 in a tax year (plus any unused part of the exemption for the previous tax year).

3 Small gifts

Outright lifetime gifts to any one person in a

tax year are exempt if the value of all gifts in that year to that person does not exceed £250.

4 Normal expenditure out of income

Lifetime gifts made from income are exempt to the extent that they form part of normal (i.e. habitual) expenditure while leaving the donor sufficient income to maintain his or her usual standard of living.

5 Gifts in consideration of marriage

The main exemptions are for gifts up to £5,000 if the donor is a parent of one of the marriage partners, and up to £2,500 if a grandparent or great-grandparent.

6 Charities

Gifts and bequests to UK charities are wholly exempt. From 6 April 2012 where 10% or more of a deceased's estate is left to charity, the rate of IHT on the rest of the estate will be reduced to 36%.

Special Reliefs

There are special reliefs for transfers of particular types of property. The most important of these reliefs are Business Property Relief and Agricultural Property Relief.

1 Business Property Relief (BPR)

BPR is available for certain business property which has been owned by the transferor for at least 2 years. The relief is given against the value of the relevant business property. Different rates of relief are available according to the class of property and assuming that all the necessary conditions are satisfied.

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Broadly, BPR at 100% (i.e. complete exemption) is available for:

- a a business (e.g. a sole trader) or an interest in a business (e.g. the share of a partner);
- b unquoted shareholdings.

Broadly, BPR at 50% is available for:

- c quoted controlling shareholdings;
- d property, plant or machinery used by a partnership or controlled company.

Shares dealt with on the Unlisted Securities Market and the Alternative Investment Market are treated as unquoted for BPR purposes.

2 Agricultural Property Relief (APR)

APR is available for certain agricultural property; this is limited by a number of conditions and applies only to the agricultural value of property.

Broadly, APR at 100% is available for:

- a agricultural land owned by the transferor for at least 2 years and occupied by the transferor for agricultural purposes;
- b let agricultural land owned by the transferor for at least 7 years and occupied for agricultural purposes if the transferor's interest carries the right to vacant possession within 12 months (or 24 months by concession);
- c let agricultural land owned by the transferor for at least 7 years and occupied for agricultural purposes if the tenancy began on or after September 1, 1995.

Broadly, APR at 50% is available for agricultural land owned by the transferor for

at least 7 years and let on a tenancy which started before and continues after September 1, 1995 where the transferor's interest does not carry the right to vacant possession within 12 months (or 24 months by concession).

As regards both BPR and APR, where a lifetime transfer of business or agricultural property has been made, and the donor dies within 7 years, no relief will be available on the donor's death unless the donee has retained the business or agricultural property (or qualifying replacement property) and the other conditions for relief are still satisfied.

Settled Property

Until the Budget on 22 March 2006 the charge to IHT on settled property varied according to the type of settlement. With some exceptions relating to Life Interest Trusts, trusts are now taxed as Discretionary Trusts. They are treated as independent taxable entities and, instead of the trust being taxed on death, it is charged at lower rates (presently not exceeding 6% on any one occasion) every 10 years, or when capital distributions are made from the trust fund.

Separate information sheets are available on Discretionary Trusts and Life Interest Trusts.

Disclaimer

This information sheet is written as a general guide. As any course of action must depend on your individual circumstances, you are strongly recommended to obtain specific professional advice before you proceed.

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We do not accept any responsibility for action which may be taken as a result of having read this information sheet.

NOTE: The law is stated as at 6 April 2011.

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* All references to the term 'spouse' include a civil partner as defined by Section 1 of the Civil Partnership Act 2004.

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