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## Chapter 8

# Inheritance tax

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## Chapter 8

# Inheritance tax

Capital Transfer Tax was introduced in 1975 and was replaced by Inheritance Tax in 1986. The difference between the two taxes is that, under Inheritance Tax, most gifts are exempt except for gifts made in the last seven years of an individual's life – which are potentially taxable on death – and a small number of other gifts, notably gifts to trusts, which may be taxable during an individual's lifetime.

Inheritance Tax has become a political issue. Originally designed to catch only the very wealthy in its net, its tentacles have now spread to a very large number of home-owners, especially in London and the South-East, where house prices tend to be higher than the average. Between 1998 and 2005, the average house price nationwide rose from £72,000 to £164,000 while the Inheritance Tax threshold rose from £223,000 to only £275,000. So a house alone will in many cases be sufficient to ensure an Inheritance Tax liability. In the five years to 2004, the number of estates paying Inheritance Tax rose by 72%. Owners of businesses will generally own other assets in addition to their houses, and careful planning is necessary to maximise the wealth which can be passed on to the next generation.

## General principles

### Lifetime transfers

Most transfers made during an individual's lifetime are exempt from Inheritance Tax at the time of the transfer. They may, however, fall within the scope of Inheritance Tax on the individual's death if they are 'transfers of value' – in other words, a gift or a sale made at an undervalue. In this case, they become potentially exempt transfers.

If the transferor survives more than seven years after the date of the gift, there is no Inheritance Tax. Death within seven years of the transfer will mean that it will form part of the transferor's estate for Inheritance Tax purposes, although taper relief (see below) will apply to transfers made between three and seven years before death.

The most common example of a chargeable lifetime transfer is one into a trust. As explained at chapter 9, since 22 March 2006 transfers to interest in possession trusts and accumulation and maintenance trusts are brought into the charge, which previously applied only to discretionary trusts.

When a chargeable lifetime transfer is made, it is aggregated with the total of all the chargeable lifetime transfers in the previous seven years. If the total exceeds the nil rate band for the year of the transfer (£285,000 in 2006/07), Inheritance Tax is payable on the excess at 20%.

### **Death estate**

The estate on death includes all property owned by the individual less liabilities. To this are added potentially exempt transfers and chargeable lifetime transfers made in the seven years before death, and the excess over the nil rate band is charged at 40%. Any tax paid on chargeable lifetime transfers within the last seven years is deducted from the Inheritance Tax bill.

There are several means of reducing the death estate and therefore the Inheritance Tax liability, and the remainder of this chapter explains how to achieve this.

### **Taper relief**

If death occurs within three years of a potentially exempt transfer, the full amount of the transfer is added to the estate. If, however, death occurs between three and seven years, taper relief is applied, reducing the Inheritance Tax payable as follows:

Death between	Reduction
3 and 4 years	20%
4 and 5 years	40%
5 and 6 years	60%
6 and 7 years	80%

Although precise planning is by nature impossible, prudent individuals will plan ahead and distribute gifts during their lifetimes in the hope that they will survive long enough for Inheritance Tax to be reduced or even not to apply at all.

**EXAMPLE:**

Mr Shere dies on 1 January 2007 leaving an estate of £100,000. He made potentially exempt transfers (net of the annual exemption) of £150,000 on 1 February 2001 and £200,000 on 1 March 2003.

Calculate his Inheritance Tax liability on death.

	£	£
Potentially exempt transfer 1 February 2001		150,000
Nil rate band		<u>(285,000)</u>
Chargeable to Inheritance Tax		<u>–</u>
Potentially exempt transfer 1 March 2003		200,000
Nil rate band	285,000	
Less transfers in previous seven years	<u>(150,000)</u>	
		<u>(135,000)</u>
Chargeable to Inheritance Tax		<u>65,000</u>
Inheritance Tax at 40%		26,000
Taper relief at 20%		<u>(5,200)</u>
Inheritance Tax payable		<u>20,800</u>
Death estate		<u>100,000</u>
Inheritance Tax at 40% (nil rate band fully utilised by potentially exempt transfers)		<u>40,000</u>
Total Inheritance Tax		<u>60,800</u>

**Gifts with reservation**

A word of warning – a potentially exempt transfer may be seen as a ‘gift with reservation’ if the transferee does not genuinely take possession of it. Parents may give an antique to their children but continue to have it in their home. They are still enjoying and benefiting from it, and therefore the transfer is treated as if it had never been made. It will not be a potentially exempt transfer and instead will form part of the death estate.

Likewise, parents often transfer their home into the name of their children but continue to live in it. Again, this is seen as a gift with reservation. The only way to avoid this is by paying the children a market rent for occupation.

Gifts made before 18 March 1986 can never be treated as gifts with reservation.

There is an important let-out from the gifts with reservation rule. An individual transferring a half share in a property to another individual is not seen as having made a gift with reservation if the transferor continues to meet the relevant share of the expenses. This is often used by parents who wish to give a share of the family home to their children who live with them, but professional advice is recommended before relying on this. A gift of more than a 50% share may well fail.

Some individuals use equity release schemes to generate a potentially exempt transfer. The cash from the equity release is used to buy a life policy paying out a lump sum on death. The cash paid to buy the policy is a potentially exempt transfer, while the payout on death is exempt from Inheritance Tax. However, on death there will be a chargeable gain which is calculated as the increase in value from the premium to the surrender value on the day before death.

## Exempt transfers

### Annual exemption

The wise individual will make lifetime gifts with sufficient regularity to utilise the annual exemption of £3,000. Potentially, Inheritance Tax of £8,400 could be saved (seven years' annual exemptions of £3,000 at 40%). Note that the annual exemption does not apply to death transfers.

The annual exemption can be carried forward for one year only if unused.

**EXAMPLE:**

Mrs Harting makes potentially exempt transfers of £2,000 in year one, £2,500 in year two and £4,000 in year three.

	£
<b>Year one</b>	
Transfer	2,000
Annual exemption	(2,000)
	<u>          </u>
	–
Annual exemption carried forward	<u>          </u>
	1,000
<b>Year two</b>	
Transfer	3,500
Annual exemption	(3,000)
Annual exemption brought forward	(500)
	<u>          </u>
	–
No annual exemption carried forward – the remaining £500 from year one is lost.	
	£
<b>Year three</b>	
Transfer	4,000
Annual exemption	(3,000)
	<u>          </u>
	1,000

**Small gifts exemption**

Individuals may make unlimited gifts during their lifetimes (though not on death) of up to £250 per person per tax year. Note that this is a maximum – a gift of £250 will be exempt from Inheritance Tax but a gift of £300 will be a potentially exempt transfer in full.

### Gifts of assets which rise in value

If the individual owns an asset – such as a property or a stamp collection – which is expected to rise sharply in value over the coming years, it is more tax-effective to give it away now, as the increase in value will be outside the estate.

### Normal expenditure out of income

Gifts made during an individual's lifetime which can be shown to be normal expenditure paid out of after-tax income (as opposed to capital) are exempt from Inheritance Tax. The pattern of these gifts must have left the individual with enough income to live on without having to draw on capital.

Usually, birthday and Christmas presents, life policy premiums on behalf of another person and payments under deeds of covenant qualify for this exemption. Until a landmark case (*Bennett*) in 1995, the Inland Revenue (as it was then known) was more likely to allow this exemption if payments were made over at least three years, but this is no longer the case. All that is now sought is evidence of a commitment to continue making the payments.

### Marriage gifts

Lifetime gifts to either party to a marriage, provided that they are made before the wedding or there is a binding promise, are exempt from Inheritance Tax up to the following amounts:

Gift made by	Exemption £
Either parent	5,000
Grandparent or great grandparent	2,500
Bride or groom	2,500
Any other person	1,000

If a gift exceeds the maximum amount, the excess is subject to Inheritance Tax. Gifts should be conditional on the marriage taking place.

### Gifts to spouse

Transfers to a spouse are exempt whether made during the lifetime or as part of the death estate. Prudent individuals will draw up their wills accordingly, ensuring that, if they so desire, an amount up to the Inheritance Tax threshold is bequeathed to other parties and the remainder to the spouse.

**EXAMPLE:**

**Mr Hampton owns assets of £400,000 and Mrs Hampton owns assets of £150,000. They have two children. How should they draw up their wills?**

Mrs Hampton should, in the event that she predeceases Mr Hampton, leave her estate to her children as it is covered by the nil rate band. If she leaves it to Mr Hampton, the Inheritance Tax liability of his estate when he dies will be increased.

Mr Hampton should, in the event that he predeceases Mrs Hampton, leave assets to the value of £285,000 to his children and the remainder to Mrs Hampton. Her assets will then total £265,000, which is below the nil rate band.

The exemption is limited to £55,000 where a UK-domiciled spouse makes transfers to a non-domiciled spouse. Domicile rules are discussed later.

The intestacy rules treat surviving spouses harshly. If there are no children, the surviving spouse receives all the personal chattels – such as cars, furniture and jewellery – plus a legacy of £200,000 and half of the balance. The remainder passes to various relatives. If there are children, the surviving spouse again receives all the personal chattels, plus £125,000. The remainder of the estate is divided into two halves. One half passes to the children as they reach the age of majority; the surviving spouse has a life interest in the other half and receives interest from it, but it passes to the children when he or she dies.

Problems may arise if the matrimonial home is in the deceased spouse's sole name, as this may have to be sold to meet the share attributable to the children. The surviving spouse does, however, have the right to apply to the courts under the Provision for Family and Dependants Act 1975.

The Civil Partnership Act 2004 came into effect on 5 December 2005 and gives civil partners the same rights as spouses. The biggest tax advantage is the right to leave assets to a surviving partner without an Inheritance Tax liability. Cousins may become civil partners, but not parents, grandparents, siblings, aunts or uncles. Civil partners need not live together, be of any particular sexual orientation or be in a sexual relationship. Civil partnerships do also carry pitfalls: if one partner wanted to leave his or her estate to children or anyone else, the surviving partner might try to thwart that; pre-existing wills are revoked on registration of a civil partnership (as indeed they are on marriage); and if each partner has a minority shareholding in an unquoted company but the two added together form a majority holding, the valuation – and potential Inheritance Tax liability – may increase considerably.

### **Other gifts exempt both as lifetime transfers and on death**

Given that the following are exempt from Inheritance Tax on death, there is no tax benefit to be gained from making them during an individual's lifetime. If Inheritance Tax is the only consideration, it is wiser to make gifts which are exempt during one's lifetime only – the small gifts exemption, for example – and leave the following in the will.

Gifts to charities which either are registered or operate within the UK are exempt from Inheritance Tax.

Gifts to political parties are exempt if the party had two Members of Parliament elected at the last General Election, or one Member of Parliament and a total of 150,000 votes polled.

Gifts to numerous national bodies are exempt. They include the National Trust, the National Gallery, the British Museum, a health service body and any government department.

## **Reliefs**

So far in this chapter we have looked at various ways of reducing Inheritance Tax by making gifts largely of personal assets. There are two reliefs which relate specifically to businesses and provide significant opportunities for tax planning: business property relief and agricultural property relief.

### **Business property relief**

Business property relief (BPR) reduces the value of business property in the death estate and in lifetime transfers. In most cases, provided that certain conditions are met, the value is reduced by 100% – in other words, no Inheritance Tax is payable.

The principal classes of business property are:

- A sole trader's business, or a partner's share in a partnership (100% relief).
- Shares in an unquoted company (100% relief).
- Shares in a quoted company controlled by the transferor (50% relief).
- Land and buildings or plant and machinery owned by the transferor and used in the transferor's business or in a company which the transferor controls (50% relief).

It is important that businesses must be trading. The definition of a trading company is more relaxed than in other areas (for example, holdover relief from Capital Gains Tax, which requires that less than 20% of the net worth of a company be made up of investments – see chapter 7). As long as a business is predominantly trading and does not hold investments which are worth more than half its value, it will qualify for BPR. It is important to take this into account when planning for Inheritance Tax, as the tax saving can be significant.

Although furnished holiday lettings qualify as a trade for Income Tax and Capital Gains Tax purposes – for example, they are a business asset for Capital Gains Tax taper relief – they do not qualify for BPR.

There is a minimum ownership period of two years. Shares must have been owned for two years, and other assets must have been used in the business for two years.

There is a relaxation of the two-year rule. If the shares or assets have been owned for less than two years but they replaced other property which would have met the criteria for BPR, they will qualify provided that the combined ownership period is at least two out of the last five years before the transfer.

#### **EXAMPLE:**

**Mrs Warwick owns a building which she uses in a company controlled by her between 1 January 2004 and 31 December 2004. She sells the building and buys a replacement on 1 June 2005.**

In order to claim BPR on the replacement building, she must own it at least until 1 June 2006 before transferring it.

BPR is given automatically on property which forms part of an individual's estate. If the property is transferred during an individual's lifetime, it will be a potentially exempt transfer and will be exempt from Inheritance Tax if the transferor survives for seven years. If the transferor dies within seven years, there will potentially be a charge to Inheritance Tax, and BPR can then apply. There is, however, an important condition: the transferee must still own the property at the transferor's death. If the property has been sold on in the meantime, or even if it is the subject of a binding contract for sale, BPR will not apply. It is important to make the transferee aware of this condition, as the potential Inheritance Tax bill could be significant.

**EXAMPLE:**

Mr Alton has an estate of £400,000 which includes shares in an unquoted company valued at £150,000. He dies on 1 January 2007 having made a potentially exempt transfer of £50,000 on 1 January 2005.

	£	£
Cumulative total brought forward (after annual exemptions)		44,000
Estate	400,000	
Less BPR	<u>(150,000)</u>	
		<u>250,000</u>
		<u>294,000</u>
Inheritance Tax:		
£285,000 at nil		
£9,000 at 40%		<u>3,600</u>

**Agricultural property relief**

Less common than business property relief, agricultural property relief (APR) nevertheless deserves a mention. In principle it operates in the same way as business property relief, but it applies to agricultural land or pasture, including buildings used in connection with the rearing of livestock or fish, farm buildings, stud farms and shares in a farming company.

Relief is usually given at 100% of the agricultural value, provided that the transferor occupied the property for the two years prior to the transfer, or owned it for seven years while it was in agricultural use. The agricultural value is not necessarily the value of the land, but the value it would carry if there were a covenant restricting it to agricultural use.

Taxpayers frequently confuse Capital Gains Tax and Inheritance Tax and assume that private residences are exempt from Inheritance Tax. This is not usually the case. However, the APR provisions often result in a farmhouse becoming exempt. Farmers who wish to retire from farming should plan carefully if they wish to minimise Inheritance Tax. If they sell the land but continue to live in the house, APR will be lost because it is no longer being used for agricultural purposes. The same will apply if they rent the farm out and continue to live in the house.

It may be more beneficial to continue farming but enter into an arrangement with a subcontractor.

## Domicile

Domicile was defined for Income Tax purposes in chapter 4. Individuals domiciled in the UK are liable to Inheritance Tax on lifetime and death transfers of property situated anywhere in the world.

The definition of domicile for Inheritance Tax purposes, however, goes further than for Income Tax. Individuals who have been domiciled in the UK at any time during the last three years before a transfer are treated for Inheritance Tax purposes as if they were domiciled at the time of transfer. Additionally, an individual who has been UK-resident for at least 17 of the last 20 tax years ending with the year of transfer is also treated as UK-domiciled for Inheritance Tax purposes.

An individual who is not UK-domiciled is liable to Inheritance Tax only on UK property. This includes bank accounts in the UK, shares registered in the UK and life policies payable in the UK. Becoming non-domiciled will therefore not affect the Inheritance Tax treatment of these assets. An individual becoming non-domiciled who wishes to transfer non-UK property, however, should wait until at least three tax years have passed since becoming non-resident. The transfers will then fall outside the scope of UK Inheritance Tax – although they may be taxed in the new country of domicile.

In certain circumstances, Inheritance Tax may be payable in two countries – for example, if an individual is domiciled elsewhere but has property in the UK. In most cases, double taxation agreements exist, and even if they do not in a particular case, a credit for the foreign tax may be allowed against the UK Inheritance Tax liability.

The £55,000 limit on transfers to a non-domiciled spouse could create problems and opportunities. A couple retiring abroad will find that any transfers between them – even of UK property – will be exempt from Inheritance Tax but only to the extent of £55,000. To avoid this situation, transfers of property should be made either before they leave the UK or in the first three years after they leave, when they will still both be treated as UK-domiciled for Inheritance Tax purposes.

Transferred assets are not only exempt from Inheritance Tax but may also be exempt from Capital Gains Tax if only one spouse is non-domiciled. The asset can be gifted from a UK-domiciled spouse to a non-domiciled spouse, transferred out of the UK and then sold. This is because individuals who are not domiciled in the UK are taxed only on gains on assets situated in the UK. Gains on assets situated overseas are taxed only if the proceeds are remitted to the UK.

## Interaction with Capital Gains Tax

The death estate is not subject to Capital Gains Tax. This is just as well, as legatees would otherwise be hit with both Capital Gains Tax and Inheritance Tax. This rule is extended so that transfers made *donatio mortis causa* – in contemplation of death, usually when the transferor is on the death-bed – are treated in the same way as death transfers.

Legatees are deemed to have acquired the asset at its market value at the date of death, which is important for the future computation of Capital Gains Tax.

Unfortunately, lifetime transfers may be subject to both Capital Gains Tax (the disposal proceeds of a gift being treated as market value) and Inheritance Tax. If the resultant chargeable gains fall below the annual exemption of £8,800 for Capital Gains Tax, this should not be a problem. By using the annual exemption and making only small gifts, both taxes can be avoided.

As outlined at chapter 7, gifts of certain assets can qualify for holdover relief, whereby the chargeable gain at the time of the gift is deferred and rolled into the deemed cost to the donee. If the transferor subsequently dies within seven years, this may create an Inheritance Tax charge. The donee may reduce any chargeable gain on the subsequent sale of the asset by any Inheritance Tax attributable to the asset.