A valuable inheritance

Inheritance tax planning may not be a routine annual compliance function, but Lerona Waskar explains that simple steps can reduce eventual liabilities.

Most tax professionals are familiar with the ‘death and taxes’ quote, although many wrongly attribute its origin to Benjamin Franklin, as opposed to Daniel Defoe writing in 1726 in *The Political History of the Devil*. Even then that was apparently preceded (caveat Wikipedia) by Christopher Bullock some ten years earlier.

However, in combining the two, it is apparent that inheritance tax is something that many advisers shy away from. This is most likely because it is not as familiar as an annual tax compliance function, although clients’ claims for immortality may also be involved. So this article seeks to provide a brief overview of the basics, starting with a little background and a few basic concepts before putting a tiny toe into the vast waters of inheritance tax planning.

The current rules governing inheritance tax are contained in IHTA 1984. In fact, this was a function of FA 1986, s 100, which formally changed the name of capital transfer tax to inheritance tax and the Capital Transfer Tax Act 1984 to the Inheritance Tax Act 1984. However, there exists a long history before 1984; estate duty was introduced in 1894 and we can go back to 1694 when probate duty was brought in as a tax on wills proved in court.

Key points

- Inheritance tax is charged on the value transferred under a ‘lifetime transfer’ or ‘transfer at death’.
- Most lifetime transfers will be potentially exempt transfers.
- A chargeable lifetime transfer is subject to inheritance tax immediately at 20%.
- Non-UK assets held by a non-domiciled individual are excluded property.
- Several exemptions and reliefs can reduce inheritance tax liability.
- At a distressing time, financial matters are not uppermost in relatives’ minds but simple planning can make a significant difference to inheritance tax liabilities.

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Inheritance tax is charged on the value transferred (under the ‘loss to donor’ principle) on a *chargeable transfer*. Such a transfer takes place on two occasions: a ‘lifetime transfer’ or ‘transfer at death’.

Lifetime transfer

Most lifetime transfers are gifts to individuals. Generally, any lifetime gift from one individual to another is a potentially exempt transfer (PET) and, as the name suggests, the gift is potentially exempt from an inheritance tax charge. The gift will be taxable only if the donor dies within seven years of making the transfer; otherwise, no inheritance tax is payable during the lifetime of the donor.

The converse of a PET is a chargeable lifetime transfer (CLT), which is subject to inheritance tax immediately and at the lifetime tax rate of 20%. A CLT includes any transfer that is not a PET or a specifically exempt transfer. One of the most common examples of CLT is a gift to a discretionary trust.

Transfer at death

There are three types of transfers that will become taxable on the death of an individual:

- The net assets comprised in the estate immediately before death.
- A PET made in the previous seven years.
- A CLT made in the previous seven years.

The inheritance tax rate applicable at death is 40%, although this is reduced to 36% if at least 10% of the net value of the estate is left to charity. Either rate means additional tax will be due on CLTs if the donor dies within seven years of the gift. HMRC will give credit for any lifetime inheritance tax paid on the CLT that becomes liable on death. However, if the lifetime tax exceeds that on death, no refund will be made; it will merely reduce the inheritance tax on death to zero.

The effective rate of inheritance tax on an estate can be reduced by claiming quick succession relief if the same asset is otherwise subject to tax within five years.

Domicile and excluded property

The concept of domicile is hugely important when determining inheritance tax chargeability. Generally, individuals who are UK domiciled, including deemed domiciled, are liable to inheritance tax on worldwide assets. In contrast, non-UK domiciled individuals are liable to tax on UK-sited property only.

Aligned to domicile status therefore, some assets (known as excluded property) will fall outside the scope of inheritance tax.

In essence, non-UK assets held by an individual who is not domiciled in the UK are excluded property. This extends to settled property sited abroad as long as the settlor was non-UK domiciled when the settlement was made, although F(No 2)A 2017 has added considerably to the complexity around this. Gilts are excluded property if the donor is non-resident in the UK at the date of transfer. Further details on excluded property can be found at IHTA 1984, s 6.

Foreign currency bank accounts held by individuals who are neither UK resident nor UK domicile are also excluded property for inheritance tax under IHTA 1984, s 157.

Given the potential exclusion of foreign assets, it is always necessary to determine the correct situs of an asset. For example, a luxury yacht could be subject to inheritance tax if, at the date of death, it is within UK territorial waters even if it was first registered offshore.

Exemptions, reliefs and tax planning

Although inheritance tax has significant reach, there are many reliefs and exemptions, some more widely used than others, that can reduce exposure. There are several specific types of transfer that are exempt from inheritance tax.

Spouse/civil partners

No tax is payable on transfers to a spouse or civil partner during lifetime or on death (IHTA 1984, s 18). This makes it a useful tool to reduce the overall inheritance tax liability of an individual, especially when combined with other tax exemptions, such as for capital gains tax, and much inheritance tax planning therefore centres on second death.

Imagine a scenario in which a rental property, jointly owned by Mr and Mrs A, is expected to be sold in the next few years. The asset has been owned for many years and a significant capital gain has potentially arisen, and is likely to be taxed at 28%. Due to the deteriorating health of Mrs A, Mr A could gift his share of the asset to his wife with no inheritance tax or capital gains tax consequence. When Mrs A dies the asset can be transferred to Mr A from her estate, again with no inheritance tax consequence. But because the asset is now inherited by Mr A at its probate value, it has an enhanced base cost, thereby reducing the capital gains tax on its eventual sale.

One important point to watch for in relation to joint property holding is whether this is held as a joint tenancy or as tenancies in common. If the former, the property will pass automatically to the surviving spouse. The latter could create a little more flexibility in inheritance tax planning in some circumstances.

One exception to this general transfer exemption is if the donor is UK domiciled while the recipient spouse or civil partner is not. In this case, only the first £325,000 of the transfer is exempt. Note that this limit was only £55,000 before 2013.

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Gifts on marriage

Lifetime gifts on marriage are exempt from inheritance tax and can be a good way to transfer valuable assets (say, a family heirloom) to your kin. The amount of exemption depends on the relationship between the donor and the recipient as follows:

Gift	Exempt amount
Parent to son or daughter	£5,000
Grandparent to grandchild	£2,500
To any other individual	£1,000

Annual exemption

Every individual is entitled to an annual exemption of £3,000, which can be carried forward for one year. However, the current year's exemption is allocated to the transfers in that year (in chronological order) before allocating the previous year's (IHTA 1984, s 19).

The exemption is available to an individual as well as the gift on marriage exemption. This can significantly increase the total exemption available to an individual.

Let's assume that no other gifts were made in the previous and the current year, the total value of exempt transfer an individual could make on the marriage of their son or daughter can be calculated as:

	£
Exempt gift on marriage of son/daughter	5,000
Annual exemptions:	
Current year	3,000
Previous year	3,000
Total exempt	11,000

Gifts to charity

A gift to a UK or EEA charity is completely exempt from tax (IHTA 1984, s 23). This exemption also includes gifts to other bodies such as political parties, housing associations, or national heritage bodies. However, as some major donors are now finding out, gifts to the Brexit referendum campaign are not exempt.

Gifts out of normal income

This can be an extremely important relief that is often overlooked. In essence, there is an underlying condition that the donor must be able to maintain the same standard of living after making the gift. IHTA 1984, s 21(1) says: 'A transfer of value is an exempt transfer if, or to the extent that, it is shown:

a) that it was made as part of the normal expenditure of the transferor; and
b) that (taking one year with another) it was made out of his income; and
c) that, after allowing for all transfers of value forming part of his normal expenditure, the transferor was left with sufficient income to maintain his usual standard of living.'

Here, 'normal' is not defined but in 1998, in reply to questions raised by the Committee of the Association of Corporate Trustees, HMRC stated: 'There is no rule of thumb. We basically judge each case on its merits. We do look very closely at the standard of living of the transferor. The test of normality requires patterns of giving to be established. That is why it is not always possible to say that, at the time it is made, a particular gift is or is not exempt as normal.'

Tolley's *Inheritance Tax Annual* suggests that, generally, HMRC does not review cases if the gift out of income is no greater than one-third of net income.

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Nil rate band (NRB)

Once all appropriate exemptions have been deducted, every individual then has a nil rate band (NRB), currently £325,000. This means the first £325,000 of transfers are charged at a 0% inheritance tax rate before the 40% rate applies. As for the annual exemption, transfers are set against the NRB in chronological order.

However, the NRB will be reduced by transfers made in the previous seven years, in chronological order. So records of non-exempt transfers must be maintained properly.

If a spouse or civil partner dies without using all of their NRB, the unused proportion can be applied on the death of the second spouse or civil partner. A claim must be made by the executors on the second death. This uplift in the NRB cannot be claimed for lifetime transfers (IHTA 1984, s 8A).

As an example, if Mr A dies leaving all his assets to Mrs A, 100% of his NRB is unused. Therefore, when Mrs A dies, her NRB is uplifted by 100%. Under the current threshold, Mrs A will have a NRB of £650,000.

Residence nil rate band

From 6 April 2017, if an individual dies and leaves their home to their direct descendent (closely inherited), they would be entitled to the additional residence nil rate band (RNRB). This is calculated as the lower of the value of the home and the maximum additional threshold, currently £125,000 (£150,000 for 2019-20). The additional threshold is tapered by £1 for every £2 that the total value of the estate is more than £2m. More details can be found in IHTA 1984, s 8D to 8M.

Further, as in the case of normal NRB, the unused proportion of the RNRB can be claimed by the executors of the second spouse as long as a home is passed to their direct descendants and is included in the estate. If the first spouse or civil partner died before 6 April 2017, 100% of the RNRB will be available to be claimed. That is unless their total estate is above £2m and their additional threshold is tapered away.

The RNRB may still be available to an individual if they have downsized to a less valuable residence (IHTA 1984, s 8FA) or have ceased to own a residence (IHTA 1984, s 8FB) on or after 8 July 2015. This applies only if the death occurs on or after 5 April 2017 and the new home or, if the individual has ceased to own one, at least some of the other assets are inherited by direct descendants (closely inherited). See 'Property Pinball' (*Taxation*, 26 January 2017) for a more detailed explanation of these rules.

Business property relief

Business property relief (BPR) is available to individuals to reduce inheritance tax on the transfer of 'relevant business property'. Relief is available at either 100% or 50% depending on the type of relevant property as listed below:

Property	Relief
An interest in a business including a partnership	100%
Shares in an unquoted trading company (including AIM-listed)	100%
Shares in a quoted trading company – if the donor has voting control	50%
Land and buildings/machinery used in company controlled by the donor	50%

Although eligible shares can include those in an overseas company, an investment company or property dealing company does not qualify for BPR. This is on the basis that a distinction needs to be drawn between a business and an investment. A business can include a trade or profession but is generally wider than that, encompassing situations in which there is activity aimed at generating a profit. However, a business interest or shares in a company will not be 'relevant business property' if the underlying business consists wholly or mainly of one involved in holding or dealing with investments, including investments in land.

Some of the main conditions relating to BPR include:

1) *Ownership requirement:* IHTA 1984, s 106 states that the donor must have owned the property for at least two years before the transfer. However, there are exceptions to the general rule:
   - Replacement property. If an old relevant business property is sold and replaced by a new one within three years, BPR will be available on the new property.

This is as long as the aggregate ownership of both the properties is more than two out of five preceding years (IHTA 1984, s 107). However, note that the BPR on the new property cannot exceed the relief that would have been available on the original one.
- Spouse/civil partner. If an individual inherits a property on the death of their spouse or civil partner, the period of ownership can be aggregated (IHTA 1984, s 108).
- Successive transfers. If there have been two successive transfers of a relevant property within two years, BPR will be available on the second transfer. This applies even when the period of ownership is less than two years if BPR was available on the first transfer and either of the two transfers was on death (IHTA 1984, s 109).

2) *Excepted assets.* BPR is restricted if the company holds excepted assets. In essence, excepted assets are those that are not used for a business purpose for at least two years before the transfer and are not required for future use in the business. These include investment shares as well as large cash deposits not required for future use in the business. It would therefore be advisable to earmark the cash deposits for a future potential business expense to demonstrate its future business use (IHTA 1984, s.112).

Agricultural property relief

Agricultural property relief (APR) reduces the value of the transferred property in much the same way as BPR. Agricultural property includes farmland and farm building in the UK, the Channel Islands, the Isle of Man or an EEA state. APR is given on the 'agricultural value' of the property which is usually different from its market value.

Landlords are given APR at 50% if the land is tenanted, the lease is dated before 1 September 1995 and there are more than two years remaining on the lease at the date of transfer.

In all other cases the APR is given at 100%.

As for BPR, there are other requirements to qualify for APR, but only in terms of ownership requirement.

The property should be owned and occupied for agricultural purposes for at least two years before the transfer. The ownership period is extended to seven years for tenanted property. As before, there are exceptions to the general rule.

- *Replacement property.* If old agricultural land is replaced by new agricultural land, the combined ownership period of both lands should be more than two years out of five preceding years. This is extended to seven out of ten preceding years for tenanted property (IHTA 1984, s 118).
- *Spouse or civil partner.* If an individual inherits a property on the death of their spouse or civil partner, the period of ownership can be aggregated (IHTA 1984, s 120).
- *Successive transfers.* As for BPR, if there have been two successive transfers of the agricultural property within two years, APR will be available on the second transfer. This is the case even if the period of ownership is less than two years, if APR was available on the first transfer and either of the two transfers was on death (IHTA 1984, s 121).

Remember that APR will take a priority if a farming business qualifies for both APR and BPR.

Treatment of debts

If an asset is transferred together with a debt attached to it, the amount of the debt is deducted from the value of the asset to reflect the true loss of value to the donor. Accordingly, much attention has focused on the treatment of debts, resulting in various anti-avoidance legislation over the years.

As for lifetime transfers, the debt is set against and reduces the value of the asset against which the debt is secured in the death estate. This could waste the relief on the debt if the underlined asset is exempt from inheritance tax – say if the asset is transferred to a spouse. Therefore, securing the debt on a chargeable asset can help to reduce the liability (IHTA 1984, s 162).

> “Modifications made in FA 2013 have considerably reduced the tax advantage of s 162.”

However, modifications made in FA 2013 have considerably reduced the tax advantage of s 162. Restrictions have been placed on the deduction if the debt was used to acquire, maintain or enhance excluded property (IHTA 1984, s 162(A)) or to acquire, maintain or enhance assets qualifying for either BPR or APR (IHTA 1984, s 162(B)). In such cases, the debt cannot reduce the value of other chargeable assets.

- *Excluded property.* The restriction applies to deaths on or after 17 July 2013 irrespective of when the loan was taken out.
- *BPR and APR.* The restriction applies to deaths on or after 17 July 2013 and if the loan was taken out on or after 6 April 2013.

Conclusions

In life, it's not always easy to deal with death. At what can be a hugely distressing time, financial matters are not uppermost in relatives' minds. However, with professional and sometimes simple planning, using the available reliefs and exemptions, a significant difference can be made to the estate being passed on to the surviving beneficiaries.

Planning points

If a spouse or civil partner dies without using all of their nil rate band, the unused proportion can be applied on the death of the second spouse or civil partner.

Author details

Lerona Waskar is a tax senior at Elman Wall. She can be contacted by email: Lerona.Waskar@elmanwall.co.uk.

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