Inheritance Tax – Main Relief's & Exemptions

Note: This note is updated when legislation changes which may be frequently.

Inheritance Tax - Generally

Inheritance Tax is a tax on capital. It is analogous to capital gains tax. It is applied to the assets of a deceased persons estate before they are transferred to his or her beneficiaries. This note describes the principal exemptions that are available to most tax payers.

Inheritance Tax – Planning

Proper and early planning can generally be successful in mitigating or avoiding Inheritance Tax. Inheritance tax mitigation is a complex area and you should seek our advice on any action you are contemplating.

Inheritance Tax – Main Relief's

1. Transfers between spouses and civil partners.

Generally all transfers between spouses and civil partners do not attract inheritance tax. Thus if a husband dies and leaves his entire estate to his wife no Inheritance tax would be payable.

2. The Nil Rate Band

The whole of a deceased persons estate is chargeable to Inheritance tax but the regulations set an initial nil rate band of tax. As at January 2006 the nil rate band is £285,000 (2006/07) so for an estate of £400,000 the tax calculation would look as follows: -

Total Estate	£425,000	
Less NRB (06/07)	£300,000	
Amount chargeable	£125,000	
Tax at 40%	£50,000	
∴Net estate	£425,000 - £50,000	= £375,000

Each individual has the opportunity to use the nil rate band. Assuming that sufficient capital is available this opportunity can be used to reduce the ultimate tax charges. The following calculation illustrates this.

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Assume married couple with £1,025,000 estate.

Inheritance Tax payable on second death using the NRB once only.

	£1,025,000
Less NRB	£300,000
Amount chargeable	£725,000
Tax at 40%	£290,000

Net estate £1,025,000 - £290,000 = £735,000

Inheritance tax payable on second death using the NRB twice.

Gross Estate	£1,025,000	
1st death	£300,000	(to third party)
To surviving Spouse	£725,000	
2nd death	£300,000	
	£425,000	
Tax at 40%	£170,000	

∴ Tax saving £290,000 - £170,000 = £120,000.

The Government has announced that the nil rate band will increase in future years as follows:

2008/09	£312,000
2009/10	£325,000
2010/11	£350,000

3. Annual Gifting Allowance

Each individual has an annual gifting allowance of £3,000. An absolute gift of this sum can be made by any individual to anybody and has no current or future liability to inheritance tax.

4. Small gifts and gifts in consideration of marriage

All individuals are permitted to make as many small gifts of up to be not exceeding £250 to anybody. It is not permitted to make a small gift and the annual gifting allowance to the same person. Or rather you can make the gift but it would be potentially chargeable to Inheritance tax.

Gifts in consideration of marriage or civil partnership: up to £5,000 by a parent, up to £2,500 by a grandparent, or up to £1,000 by any other person.

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5. Potentially Exempt Transfers and Lifetime Transfers

Transfers on or Within Seven Years Before Death

	2007/08
Nil rate band to	£300,000
Rate of tax on balance	40%
Chargeable lifetime transfers	20%

All lifetime transfers not covered by exemptions and made within seven years of death will be added back into the estate for the purpose of calculating the tax payable. This may then be reduced by taper relief

Anybody can make a gift in excess of any of the allowances but it will be potentially liable to inheritance tax if you die within 7 years. If you die within 7 years then the gift is brought back in to the estate and is taxed subject to a tapering scale.

Charge on Gifts Within 7 Years of Death

Years before death	0-3	3-4	4-5	5-6	6-7
Tax reduced by	0%	20%	40%	60%	80%

For example:-

Gift of £10,000 made 01/04/2003
Donor passes away 01/04/2008

Therefore survives 5 years. Tax charge reduced by 60%.

£10,000 x 40% = £4000 x 60% = £2,400 tax to pay.

6. Regular small gifts from income

This is a much-overlooked opportunity. The revenue permits regular payments from income to be exempt from inheritance tax. The rule is that they should not be of such a level as they affect your lifestyle. This concession is generally assumed to be for the payment of premiums to appropriate life insurance policies. However the definition is quite wide and the limits can be generous so it is worth considering for those people whose assets are sufficient to make it viable.

7. Business Property Relief

This area requires more specialist advice. The main allowances are:-

business or interest therein	100%
qualifying shareholders in unquoted* companies	100%
land, buildings, machinery, or plant used by transferor's controlled company or partnership	50%
Agricultural property	50% or 100%

*Unquoted companies include those listed on AIM

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8. Other Opportunities

There are other exemptions such as gifts to recognised charities and political parties and the like. There are also reduced rates of tax for lifetime transfers but the foregoing are the principal exemptions that can be exploited.

Mitigation of inheritance tax is a complex area and needs to be properly considered. Many of the more exotic schemes are expensive and in most cases unsafe. Plus the catch all 'anti avoidance' legislation could be used to overturn them retrospectively leaving clients with large unexpected tax bills.

Our general principals are to keep things as simple as possible and to ensure that any gifts are made absolutely and all actions properly documented. It is our opinion that much can be done to reduce the effect of inheritance tax on your estate as long as you ensure that you start planning sooner rather than later.

This note reflects Williams Farrall Woodward's understanding of UK taxation and current Inland Revenue rules and practice. These are subject to change at any time. Errors and omissions are excepted.

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