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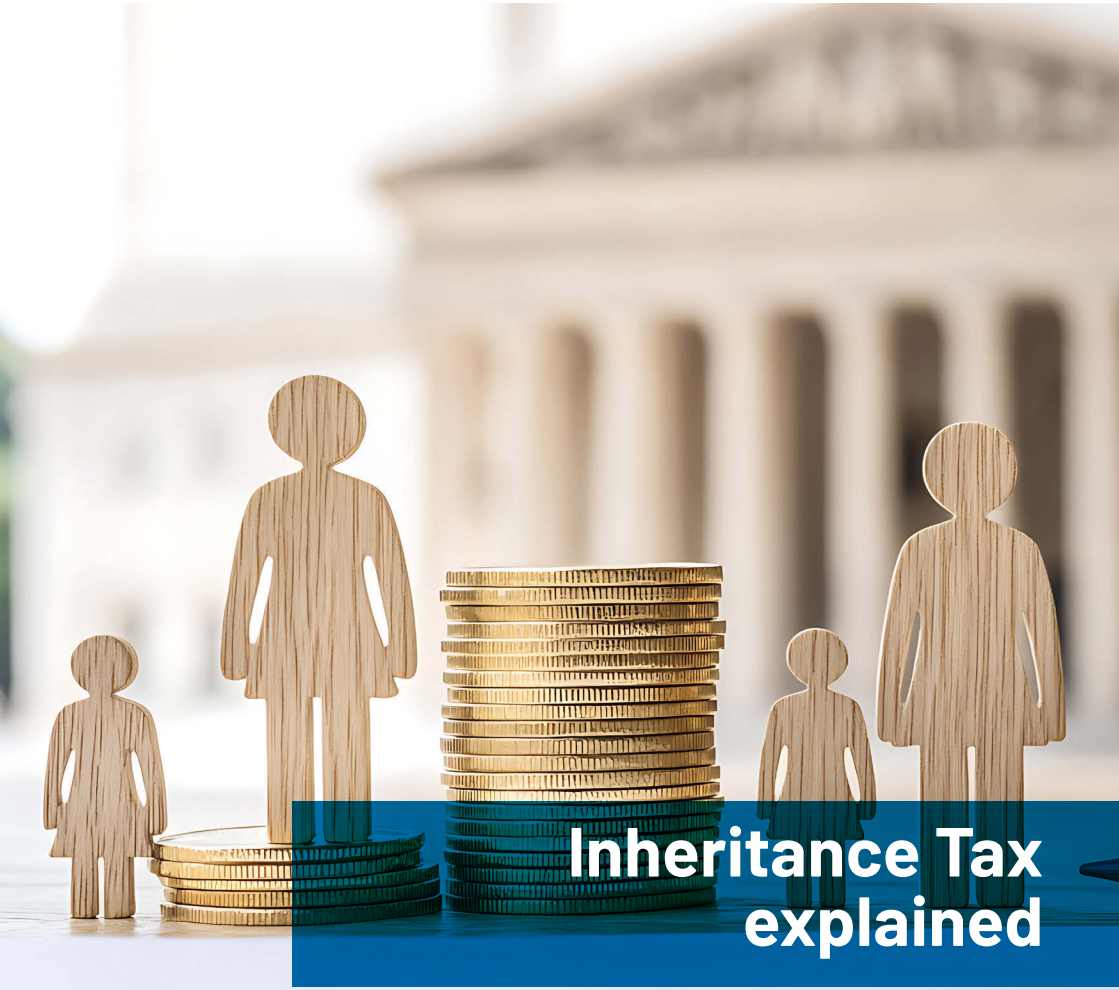

Inheritance Tax explained

With cuts to important reliefs and frozen thresholds, plus new rules for pensions in sight, Inheritance Tax (IHT) has made many headlines over recent months.

In this publication, we provide the most current information; set out circumstances in which exposure to IHT can arise, and examine what you can do to pass on your wealth and assets in line with your wishes.

Please note that for reasons of space, the term spouse refers here to both married couples and registered civil partners.

Tip: Planning will help

Planning for the future is something many people put off. Statistics suggest over 50% of UK adults don't have a will. On top of that, more than 70% don't understand how IHT works, or how it could impact their beneficiaries when they die. The reality is that advance planning invariably helps, and can give scope for significant saving.

In a nutshell

IHT can be due on the value of the estate at death over a certain threshold. This is £325,000, and is sometimes known as the nil rate band (NRB). Some lifetime gifts can also become chargeable at death. Gifts between spouses are generally exempt from IHT: the rules for couples living together are different, and generally less favourable.

IHT is charged at 40% on death on the estate above £325,000; and at 20% on certain lifetime transfers.

What IHT is charged on

The value of the estate on death above £325,000: Property, land and buildings, and stocks and shares will spring to mind, but assets ranging from cars, caravans and boats, to cash, cryptoassets, and jewellery - and much else besides - are also included in the value of the estate at death.

Tip: Latest developments bring pension assets within scope

From 6 April 2027, most unused pension funds and death benefits (but not death in service benefits payable from registered pension schemes) will be included in the value of the estate for IHT. This means that pension wealth and withdrawal strategies now need careful consideration, as without appropriate planning, pension assets could be exposed to IHT at 40% in future. Please note, however, that a pension fund left entirely to your spouse will not incur an IHT charge.

Lifetime gifts: Any lifetime gift falls into one of three categories:

- exempt gifts: these are ignored both when made and on the death of the donor
- transfers to companies or trusts (except disabled trusts): these are immediately chargeable
- other outright gifts (technically known as potentially exempt transfers, or PETs): these are, typically, gifts to another person, and IHT only becomes due if the donor dies within seven years of making the gift. Further details are given below.

IHT basics: your spouse and your home

The first questions most people have are about providing for their spouse, and what happens to the family home.

Gifts from one spouse to another, during life or on death, are exempt: there is no IHT to pay on them. This exemption for spouses applies if both are either long term UK resident (residence of at least ten years in the UK) or both are non long term resident. If only one is long term UK resident, the exemption may be restricted. We can advise further here.

The NRB has the effect of charging the first £325,000 of your estate to IHT at 0%. Any unused NRB can be transferred to the surviving spouse, effectively providing a joint threshold of up to £650,000 for couples in many cases.

As regards the family home, an additional nil rate band of £175,000 can be available if you leave an interest in a qualifying residence to your direct descendants (children/grandchildren). This is known as the residence nil rate band (RNRB). Restrictions apply where the estate, before reliefs, is more than £2 million. The RNRB can also be available where you downsize, or have ceased to own a home on or after 8 July 2015, where assets of an equal value, up to the value of the RNRB, are passed to direct descendants on death.

In practice, the rules work to allow many couples to use the NRB and RNRB to pass up to £1 million to children/grandchildren without IHT.

So when can exposure to IHT arise?

With rising prices – especially residential property prices: Put simply, it's the problem of fiscal drag. Historically, IHT has only impacted a minority of very wealthy estates. At present, however, inflation is pushing the value of property and assets up, while IHT thresholds are fixed. This is something bringing more estates within the IHT net.

By way of illustration, figures from the Office for Budget Responsibility show that average house prices have risen by more than 70% between 2009 and 2023. IHT thresholds would have needed to rise significantly to keep pace; whereas, in fact, the £325,000 threshold has been unchanged since 2009.

Tip: Be aware of asset values

IHT still only affects a minority, but the minority is getting bigger. With IHT thresholds, including the NRB, frozen until at least 2030/31, it may help if you ascertain the current value of your property and other assets. This will help quantify whether IHT is likely to be an issue, and whether action now would be beneficial.

On assets over £325,000: There is potential exposure on the value of assets in excess of the £325,000 NRB. It is also important to remember that the NRB available on death can be reduced by lifetime gifts made in the seven years before death.

Tip: Deciding on a strategy

There are usually steps that can be taken to minimise the impact of IHT. From judicious use of the IHT annual exemption, to the use of trusts; consideration of the timing of gifts in a year; and equalising assets between spouses, there are a variety of options that may be appropriate.

With change to the rules: Shifts in tax policy can have significant consequences. This is the case with recent changes to business property relief (BPR) and agricultural property relief (APR).

BPR and APR have previously provided IHT relief up to 100% on business assets, such as shares in a family trading company; and agricultural property. From 6 April 2026, however, restricted availability of 100% relief will increase exposure to IHT for some.

- Only the first £2.5 million of combined agricultural/business property benefits from 100% relief.
- 50% relief applies to qualifying assets above this level.
- The £2.5 million allowance is transferable between spouses, allowing a couple to pass on up to £5 million in qualifying agricultural/business assets. This is in addition to the existing NRB/RNRB.

- The new £2.5 million limit also applies to the combined value of relievable agricultural and business property in trusts.
- BPR available for Qualifying Alternative Investment Market (AIM) shares is reduced from 100% to 50%.

Tip: Review position for BPR and APR

The rules, as now in force, are more favourable than the initial proposals. However, we advise taking stock of your position sooner rather than later, as the cap on relief will undoubtedly mean that more businesses now need to plan for a future IHT liability.

Strategies to limit IHT exposure

Making lifetime gifts to use exemptions and reliefs can be particularly helpful, and is also beneficial in accessing a lower rate of tax on lifetime transfers. Where gifts are made, it is essential to keep appropriate records. The date of the gift, along with a description and value of what was given, and details of the recipient are needed.

The following can provide valuable planning opportunities:

Annual exemption: This allows you to give £3,000 per year to an individual without an IHT charge. Any amount unused in one year can be carried forward (for one year only) and used in the following tax year.

Gifts on the occasion of marriage/civil partnership: Up to £5,000 can be given free of IHT to your child; £2,500 to your grandchild or great-grandchild; and up to £1,000 to anyone else.

Small gifts: Gifts to another person, of not more than £250 in total per recipient, per tax year, are exempt. It is important to get the detail right here: the exemption applies to the total to the recipient. If gifts to the same recipient are more than £250 in the tax year, the total amount is no longer exempt. You can't, for example, give your daughter £5,000 as a wedding gift, as well as £250 using the small gift allowance in the same tax year.

Normal expenditure out of income: An exemption applies if you regularly make a gift to someone; and the gift is out of surplus income (not capital); and can be made without impacting your usual standard of living. This can be particularly useful, for example to pay school or university fees, or pass a particular percentage of income to the next generation each year.

Gifts to charity: These are exempt from IHT. Note also that a reduced IHT rate of 36%, rather than 40%, can apply to the rest of the estate that remains chargeable where there is substantial giving to UK charities. This is defined as 10% or more of the deceased's net estate, after various reliefs.

Tip: Make use of exemptions

The importance of these exemptions should not be overlooked. Individually, these amounts may seem relatively small. If begun as early as possible, however, and used regularly, they can help build funds outside your estate without incurring an IHT liability.

Making potentially exempt transfers: Most lifetime gifts are treated as PETs. In everyday terminology, it means there's no immediate IHT charge, and the gift falls out of the reckoning completely if the donor lives for at least seven years from the date of the gift. This applies whatever the size of the gift.

If the donor does not live seven further years, the PET becomes chargeable. This means IHT is payable on any amounts in excess of the £325,000 NRB. If the donor lives at least three years from the date of the gift, taper relief may be available.

Tip: Use of insurance

The use of life insurance can be helpful in a variety of circumstances, for example to cover potential exposure to IHT in the seven years after making a PET; as a way to remove value from the estate; or to fund IHT liabilities where assets are not easily realised.

Where trusts come in

Trusts are sometimes used as a way to transfer assets out of an estate whilst allowing the donor some ongoing influence and control.

Most gifts to trusts are what are called chargeable lifetime transfers (CLTs). These are charged to IHT at 20%, to the extent that the total amount of CLTs exceed the NRB over a seven-year period. The NRB is applied on a seven-year rolling basis, meaning that when carefully managed, gifts can be used to transfer significant amounts without an IHT liability. Note, too, that the lifetime rate of IHT is lower than the death rate, and where the donor lives for seven years after the date of the gift into trust, no further liability to IHT attaches.

It is an area of considerable complexity, and we should be pleased to provide further information if it is of interest to you.

Tip: Will planning

Having an up to date Will is central to IHT planning and facilitates effective use of available reliefs.

Here to help

Planning to reduce the value of your estate for IHT purposes is a significant step, and advice tailored to your specific circumstances is essential.

We are happy to assist you with this, for example, by assessing the impact that any gifts would have on your own cash flow and overall financial position. We can also advise on how to factor in the interaction of IHT with other taxes, such as Capital Gains Tax, or Income Tax on pensions, where appropriate. Please contact us for an in-depth discussion.

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