

# INHERITANCE TAX, PART 1

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**In the Paper F6 (UK) exam, there will always be a minimum of five marks on inheritance tax. This two-part article will look at those aspects of inheritance tax that you need to know, with this first article explaining the scope of inheritance tax**

The Paper F6 (UK) syllabus requires a basic understanding of inheritance tax (IHT), and this two-part article covers those aspects that you need to know. It is relevant to candidates taking Paper F6 (UK) in either June or December 2013, and is based on tax legislation as it applies to the tax year 2012–13 (Finance Act 2012).

There will always be a minimum of five marks (but no more than 15 marks) on IHT, with these marks being included in either Questions 3, 4 or 5.

### **The scope of inheritance tax**

IHT is paid on the value of a person's estate when they die, but it also applies to certain lifetime transfers of assets. If IHT did not apply to lifetime transfers it would be very easy for a person to avoid tax by giving away all of their assets just before they died.

As far as Paper F6 (UK) is concerned the terms 'transfer' and 'gift' can be taken to mean the same thing. The person making a transfer is known as the donor, while the person receiving the transfer is known as the donee.

Unlike capital gains tax where, for example, a principal private residence is exempt, all of a person's estate is generally chargeable to IHT.

A person who is domiciled in the UK is liable to IHT in respect of their worldwide assets. As far as Paper F6 (UK) is concerned, people will always be domiciled in the UK.

### **Transfers of value**

During a person's lifetime IHT can only arise if a transfer of value is made. A transfer of value is defined as 'any gratuitous disposition made by a person that results in a diminution in value of that person's estate'. There are two important terms in this definition:

- *Gratuitous*: Poor business deals, for example, are not normally transfers of value because there is no gratuitous intent.
- *Diminution in value*: Normally there will be no difference between the diminution in value of the donor's estate and the increase in value of the donee's estate. However, in some cases it may be necessary to compare the value of the donor's estate before the transfer, and the value after the transfer in order to compute the diminution in value. This will usually be the case where unquoted shares are concerned. Shares forming part of a controlling shareholding will be valued higher than shares forming part of a minority shareholding.

### Example 1

On 4 May 2012 Daniel made a gift to his son of 15,000 £1 ordinary shares in ABC Ltd, an unquoted investment company. Before the transfer Daniel owned 60,000 shares out of ABC Ltd's issued share capital of 100,000 £1 ordinary shares. ABC Ltd's shares are worth £8 each for a holding of 15%, £10 each for a holding of 45%, and £18 each for a holding of 60%.

Although Daniel's son received a 15% shareholding valued at £120,000 (15,000 x £8), Daniel's transfer of value is calculated as follows:

Value of shares held before the transfer	
60,000 x £18	1,080,000
Value of shares held after the transfer	
45,000 x £10	450,000
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Value transferred	630,000
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By contrast, for capital gains tax purposes the valuation will be based on the market value of the shares gifted, which is £120,000.

As far as Paper F6 (UK) is concerned, a transfer of value will always be a gift of assets. A gift made during a person's lifetime may be either potentially exempt or chargeable.

#### Potentially exempt transfers

Any transfer that is made to another individual is a potentially exempt transfer (PET). A PET only becomes chargeable if the donor dies within seven years of making the gift. If the donor survives for seven years then the PET becomes exempt and can be completely ignored. Hence, such a transfer has the potential to be exempt.

If the donor dies within seven years of making a PET then it becomes chargeable. Tax will be charged according to the rates and allowances applicable to the tax year in which the donor dies. However, the value of a PET is fixed at the time that the gift is made.

### Example 2

Sophie died on 23 January 2013. She had made the following lifetime gifts:

- 8 November 2005 – A gift of £450,000 to her son.

- 12 August 2010 – A gift of a house valued at £610,000 to her daughter. By 23 January 2013 the value of the house had increased to £655,000.

The gift to Sophie's son on 8 November 2005 is a PET for £450,000. As it was made more than seven years before the date of Sophie's death it is exempt from IHT.

The gift to Sophie's daughter on 12 August 2010 is a PET for £610,000 and is initially ignored. It becomes chargeable as a result of Sophie dying within seven years of making the gift, and the transfer of £610,000 will be charged to IHT based on the rates and allowances for 2012–13.

#### **Chargeable lifetime transfers**

Any transfer that is made to a trust is a chargeable lifetime transfer (CLT).

There is no legal definition of what a trust is, but essentially a trust arises where a person transfers assets to people (the trustees) to hold for the benefit of other people (the beneficiaries). For example, parents may not want to make an outright gift of assets to their young children. Instead, assets can be put into a trust with the trust being controlled by trustees until the children are older.

Unlike a PET, a CLT is immediately charged to IHT based on the rates and allowances applicable to the tax year in which the CLT is made. An additional tax liability may then arise if the donor dies within seven years of making the gift. Just as for a PET, the value of a CLT is fixed at the time that the gift is made, but the additional tax liability is calculated using the rates and allowances applicable to the tax year in which the donor dies.

#### **Example 3**

Lim died on 4 December 2012. She had made the following lifetime gifts:

- 2 November 2005 – A gift of £420,000 to a trust.
- 21 August 2010 – A gift of a house valued at £615,000 to a trust. By 4 December 2012 the value of the house had increased to £650,000.

The gift to the trust on 2 November 2005 is a CLT for £420,000, and will be immediately charged to IHT based on the rates and allowances for 2005–06. There will be no additional tax liability as the gift was made more than seven years before the date of Lim's death.

The gift to the trust on 21 August 2010 is a CLT for £615,000, and will be immediately charged to IHT based on the rates and allowances for 2010–11. Lim has died within seven years of making the gift so an additional tax liability may arise based on the rates and allowances for 2012–13.

#### **Rates of tax**

IHT is payable once a person's cumulative chargeable transfers over a seven-year period exceed a nil rate band. For the tax year 2012–13 the nil rate band is £325,000, and for previous years it has been as follows:



2003–04	255,000
2004–05	263,000
2005–06	275,000
2006–07	285,000
2007–08	300,000
2008–09	312,000
2009–10	325,000
2010–11	325,000
2011–12	325,000

The rate of IHT payable as a result of a person's death is 40%. This is the rate that is charged on a person's estate at death, on PETs that become chargeable as a result of death within seven years, and is also the rate used to see if any additional tax is payable on CLTs made within seven years of death.

The rate of IHT payable on CLTs at the time they are made is 20% (half the death rate). This is the lifetime rate.

The tax rates information that will be given in the tax rates and allowances section of the June and December 2013 exam papers is as follows:

£1 – £325,000	Nil
Excess – Death rate	40%
– Lifetime rate	20%

Where nil rate bands are required for previous years then these will be given to you within the question.

#### Example 4

Sophie died on 26 May 2012 leaving an estate valued at £600,000.

The IHT liability is as follows:

#### Death estate

Chargeable estate	600,000
_____	
IHT liability	
325,000 at nil%	
275,000 at 40%	100,000
_____	

**Example 5**

Ming died on 22 April 2012 leaving an estate valued at £300,000.

On 30 April 2010 she had made a gift of £240,000 to her son. This figure is after deducting available exemptions.

IHT liabilities are as follows:

**Lifetime transfer – 30 April 2010**

Potentially exempt transfer	240,000
_____	

- The PET is initially ignored.

**Additional liability arising on death – 30 April 2010**

Potentially exempt transfer	240,000
_____	

- The PET utilises £240,000 of the nil rate band of £325,000 for 2012–13. No IHT is payable.

**Death estate**

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[REDACTED]	
Chargeable estate	300,000
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IHT liability	
85,000 at nil%	
215,000 at 40%	86,000
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- Only £85,000 (325,000 – 240,000) of the nil rate band is available against the death estate.

**Example 6**

Joe died on 13 October 2012 leaving an estate valued at £750,000.

On 12 November 2009 he had made a gift of £400,000 to a trust. This figure is after deducting available exemptions. The trust paid the IHT arising from the gift.

The nil rate band for the tax year 2009–10 is £325,000.

**Lifetime transfer – 12 November 2009**

[REDACTED]	
Chargeable estate	400,000
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IHT liability	
325,000 at nil%	
75,000 at 20%	15,000
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- The gift to a trust is a CLT. The lifetime IHT liability is calculated using the nil rate band for 2009–10.

**Additional liability arising on death – 12 November 2009**

[REDACTED]	
Chargeable estate	400,000
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IHT liability	
325,000 at nil%	
75,000 at 40%	30,000
IHT already paid	(15,000)
<hr/>	
Additional liability	15,000

- The additional liability arising on death is calculated using the nil rate band for 2012–13.

#### Death estate

[REDACTED]	
Chargeable estate	750,000
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IHT liability	750,000 at 40%
	300,000
<hr/>	

- The CLT made on 12 November 2008 has fully utilised the nil rate band of £325,000.

#### Taper relief

It would be somewhat unfair if a donor did not quite live for seven years after making a gift with the result that the gift was fully chargeable to IHT. Therefore taper relief reduces the amount of tax payable where a donor lives for more than three years, but less than seven years, after making a gift. The reduction is as follows:

Years before death

Years before death	
Over three years but less than four years	20
Over four years but less than five years	40
Over five years but less than six years	60
Over six years but less than seven years	80

Although taper relief reduces the amount of tax payable, it does not reduce the value of a gift for cumulation purposes.

The taper relief table will be given in the tax rates and allowances section of the exam.

**Example 7**

Winnie died on 9 January 2013. She had made the following lifetime gifts:

- 2 November 2007 – A gift of £460,000 to a trust. The trust paid the IHT arising from this gift
- 16 August 2009 – A gift of £320,000 to her son

These figures are after deducting available exemptions.

The nil rate band for the tax year 2007–08 is £300,000, and for the tax year 2009–10 it is £325,000.

IHT liabilities are as follows:

Lifetime transfers	
<b>2 November 2007</b>	
Chargeable transfer	460,000
_____	
IHT liability	
300,000 at nil%	
160,000 at 20%	32,000
_____	
<b>16 August 2009</b>	



## Lifetime transfers

Potentially exempt transfer	320,000
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## Additional liabilities arising on death

### 2 November 2007

Chargeable transfer	460,000
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#### IHT liability

325,000 at nil%

135,000 at 40%	54,000
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Taper relief reduction – 60%	(32,400)
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21,600

IHT already paid	(32,000)
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Additional liability	Nil
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- The taper relief reduction is 60% as the gift to the trust was made between five and six years of the date of Winnie's death.
- Although the final IHT liability of £21,600 is lower than the amount of IHT already paid of £32,000, a refund is never made.

16 August 2009

Potentially exempt transfer	320,000
	_____
IHT liability 320,000 at 40%	128,000
Taper relief reduction – 20%	(25,600)
	_____
	102,400
	_____

- The taper relief reduction is 20% as the gift to the son was made between three and four years of the date of Winnie's death.

#### **Transfer of a spouse's unused nil rate band**

Any unused nil rate band on a person's death can be transferred to their surviving spouse (or registered civil partner). The nil rate band will often not be fully used on the death of the first spouse because any assets left to the surviving spouse are exempt from IHT (see the following section on transfers to spouses).

A claim for the transfer of any unused nil rate band is made by the personal representatives who are looking after the estate of the second spouse to die. The amount that can be claimed is based on the proportion of the nil rate band not used when the first spouse died. Even though the first spouse may have died several years ago when the nil rate band was much lower, the amount that can be claimed on the death of the second spouse is calculated using the current limit of £325,000.

#### **Example 8**

Nun died on 29 March 2013.

None of her husband's nil rate band was used when he died on 5 May 2002.

When calculating the IHT on Nun's estate a nil rate band of £650,000 (325,000 + 325,000) can be used, as a claim can be made to transfer 100% of her husband's nil rate band.

#### **Example 9**

Win died on 24 February 2013 leaving an estate valued at £800,000. Only 60% of his wife's nil rate band was used when she died on 12 May 2003.

On 10 May 2010 Win had made a gift of £200,000 to his son. This figure is after deducting available exemptions.

The nil rate band for the tax year 2010–11 is £325,000.

IHT liabilities are as follows:

**Lifetime transfer – 10 May 2010**

[REDACTED]	
Potentially exempt transfer	200,000

**Additional liability arising on death – 10 May 2010**

[REDACTED]	
Potentially exempt transfer	200,000

- No IHT is payable as the transfer is within the nil rate band.

**Death estate**

[REDACTED]	
Chargeable estate	800,000

IHT liability	
255,000 at nil%	
545,000 at 40%	218,000

- Win's personal representatives can claim the wife's unused nil rate band of £130,000 ( $325,000 \times 40\%$ ).
- The amount of nil rate band is therefore £455,000 ( $325,000 + 130,000$ ), of which £200,000 is utilised by the PET made on 10 May 2010.

**Exemptions**

### Transfers to spouses

Gifts to spouses (and registered civil partners) are exempt from IHT. This exemption applies both to lifetime gifts and on death.

#### Example 10

Sophie died on 25 June 2012.

On 12 April 2008 she had made a gift of £400,000 to her husband.

Her estate on 25 June 2012 was valued at £900,000. Under the terms of her will Sophie divided her estate equally between her husband and her daughter.

The nil rate band for the tax year 2008–09 is £312,000.

IHT liabilities are as follows:

#### Lifetime transfers

- The gift on 12 April 2008 is exempt as it is to Sophie's husband.

#### Death estate

Value of estate	900,000
Spouse exemption	(450,000)
	_____
Chargeable estate	450,000
	_____
IHT liability	
325,000 at nil%	
125,000 at 40%	50,000
	_____

There are a number of other exemptions that only apply to lifetime gifts.

#### Small gifts exemption

Gifts up to £250 per person in any one tax year are exempt. If a gift is more than £250 then the small gifts exemption cannot be used, although it is possible to use the exemption any number of times by making gifts to different donees.

#### Example 11

During the tax year 2012–13 Peter made the following gifts:

On 18 May 2012 he made a gift of £240 to his son.

On 5 October 2012 he made a gift of £400 to his daughter.

On 20 March 2013 he made a gift of £100 to a friend.

The gifts on 18 May 2012 and 20 March 2013 are both exempt as they do not exceed £250. The gift on 5 October 2012 for £400 does not qualify for the small gifts exemption as it is more than £250. It will instead be covered by Peter's annual exemption for 2012–13 (see the next section).

#### *Annual exemption*

Each tax year a person has an annual exemption of £3,000. If the whole of the annual exemption is not used in any tax year then the balance is carried forward to the following year. However, the exemption for the current year must be used first, and any unused brought forward exemption cannot be carried forward a second time. Therefore the maximum amount of annual exemptions available in any tax year is £6,000 (£3,000 x 2).

#### **Example 12**

Simone made the following gifts:

On 10 May 2011 she made a gift of £1,400 to her son.

On 25 October 2012 she made a gift of £4,000 to her daughter.

The gift on 10 May 2011 utilises £1,400 of Simone's annual exemption for 2011–12. The balance of £1,600 (3,000 – 1,400) is carried forward to 2012–13.

The gift on 25 October 2012 utilises all of the £3,000 annual exemption for 2012–13 and £1,000 (4,000 – 3,000) of the balance brought forward of £1,600. As the annual exemption for 2012–13 must be used first, the unused balance brought forward of £600 (1,600 – 1,000) is lost.

The annual exemption is applied on a strict chronological basis, and is therefore given against PETs even where they do not become chargeable.

#### **Example 13**

Nigel made the following gifts:

On 17 May 2011 he made a gift of £60,000 to his son.

On 25 June 2012 he made a gift of £100,000 to a trust.

The gift on 17 May 2011 utilises Nigel's annual exemptions for 2011–12 and 2010–11. The value of the PET is £54,000 (60,000 – 3,000 – 3,000).

The gift on 25 June 2012 utilises Nigel's annual exemption for 2012–13. The value of the CLT is £97,000 (100,000 – 3,000). No lifetime IHT liability is payable as this is within the nil rate band for 2012–13.

#### *Normal expenditure out of income*

IHT is not intended to apply to gifts of income. Therefore a gift is exempt if it is made

as part of a person's normal expenditure out of income, provided the gift does not affect that person's standard of living. To count as normal, gifts must be habitual. Therefore, regular annual gifts of £2,500 made by a person with an annual income of £100,000 would probably be exempt. A one-off gift of £70,000 made by the same person would probably not be, and would instead be a PET or a CLT.

*Gifts in consideration of marriage*

This exemption covers gifts made in consideration of a couple getting married or registering a civil partnership. The amount of exemption depends on the relationship of the donor to the donee (who must be one of the two persons getting married):

- £5,000 if the gift is made by a parent.
- £2,500 if the gift is made by a grandparent or by one of the couple getting married to the other.
- £1,000 if the gift is made by anyone else.

**Example 14**

On 19 September 2012 William made a gift of £20,000 to his daughter when she got married. He has not made any other gifts since 6 April 2011.

The gift is a PET, but £5,000 will be exempt as a gift in consideration of marriage and William's annual exemptions for 2012–13 and 2011–12 are also available. The value of the PET is therefore £9,000 ( $20,000 - 5,000 - 3,000 - 3,000$ ).

The second part of the article will cover the more difficult aspects of lifetime transfers, the calculation of the value of a person's estate, and the payment of inheritance tax.

**Written by a member of the Paper F6 examining team**