
Taxation: Policy and Practice (2020/21 – 27th Edition)

By A. Lymer and L. Oats

Inheritance tax supplementary section: Chapter 8 by T. Filer, Swansea University

This supplementary section supports chapter 8 capital taxes section 8.46 - Inheritance tax, extending the basic coverage provided in the textbook. Specifically it is designed to demonstrate how to calculate any inheritance tax (IHT) due.

We first discuss the basic premise on which IHT is based – i.e. the transfer of value concept. We then explore how IHT computations work in practice starting with exemptions on lifetime gifts, then the computing of any IHT due on lifetime transfers, including use of the 7 year cumulation period rules. This is followed by illustrating how death of the taxpayer affects these lifetime transfers before finally illustrating how IHT is paid on an estate once the taxpayer has died.

1. Transfer of value example

It is the diminution in value concept that sets inheritance tax apart from other UK capital taxes which are usually based on the gains made when an asset is sold or transferred e.g. Capital Gains tax (CGT) and Stamp Duty Land Tax (SDLT). This example demonstrates how the diminution in value concept works in practice where inheritance tax is calculated on the reduction in value of the individual's estate.

Activity

Jenny owns a set of 6 miniature antique paintings. On 15 June 2020, she gave one of the paintings to her friend Martin.

Valuation of the paintings has been agreed with HMRC for IHT purposes as follows:

The set of 6 miniature paintings are worth £550,000.
Individually they are worth £75,000 each.

Calculate the transfer of value relating to the gift of one of the paintings for IHT purposes only.

Feedback

Value of estate before transfer	£ 550,000
Less value of estate after transfer (5 x £75,000)	<u>-375,000</u>
Transfer of value	175,000

Lifetime gifts usually have IHT and CGT consequences; however the examples in this section will focus on the IHT consequences only. The computation for lifetime IHT that would be due on this gift for example, will be explored further in section 3 below.

The diminution of value concept demonstrated above is unique to IHT.

2. Exemptions on lifetime gifts example

Individuals can reduce the amount of inheritance tax they otherwise would have to pay by gifting (i.e. giving away) assets during their lifetime.

Gifts to a trust are categorized as chargeable lifetime transfers where inheritance tax could be payable during the individual's lifetime. For the purposes of these examples all transfers to trusts are assumed to be chargeable as this is a complex area of tax and is beyond the scope of this supplement.

All other lifetime transfers are classed as potentially exempt transfers or PET's. No inheritance tax is due on PET's during the individual's lifetime but could be payable when the individual dies if the date of death is within seven years of the date that the transfer is made.

Lifetime transfers are eligible for many exemptions. All transfers to a spouse are exempt. Three of the other main exemptions are as follows:

Annual exemption

An annual exemption of £3,000 is available in each tax year (6 April to 5 April).

Any unused annual exemption can be carried forward to the next year - for one year only.

Marriage exemption

£5,000 exemption for a child

£2,500 exemption for a grandchild or great grandchild

£1,000 exemption for any other wedding

For the exemption to apply the wedding must actually take place

Small gift exemption

A small gift exemption of up to £250 per person for each tax year applies provided there are no other exemptions for the same person.

It is beneficial for individuals to utilise exemptions to reduce any inheritance tax that may be due. Exemptions from small gifts and marriage should be utilised before the annual exemption to maximise the exemptions available.

Annual exemptions will be applied in a chronological (date) order so the timing of PET's and transfers to trusts should be considered carefully as good tax planning will ensure that any transfers to trusts should take place before any PET's to make best use of the annual exemption and reduce any inheritance tax due.

The example below illustrates these principles for you:

Activity

Jane made the following lifetime gifts:

£	Donee	Date
500	Daughter	28/08/18
900	Trust	25/10/18
2,500	Trust	20/05/19
1,500	Trust	21/11/19
6,000	Daughter	29/04/20

Calculate the chargeable amount for each of the gifts above.

Feedback

Chargeable amounts

	PET	CLT	CLT	CLT	PET	Guidance notes
						First decide if the transfer is a PET or CLT.
	28/08/18	25/10/18	20/05/19	21/11/19	29/4/20	Use date per question
Tax year of gift	2018/19	2018/19	2019/20	2019/20	2020/21	Enter the correct tax year
Transfer of value	500	900	2,500	1,500	6,000	As per question
						Consider any exemptions only the annual exemption applies here but there are others e.g. small gift <250, marriage exemption or normal expenditure out of income.

Less annual exemption						
2018/19	-500	-900				
2017/18 (all lost as unused can only c/f for one year)						
2019/20			-2,500	-500		
2018/19 b/f (3000-500-900) = 1600				-1,000		
Remaining £600 unused and now lost.						
2020/21					-3,000	
2019/20 no b/f as all used.						
Chargeable amount	Nil	Nil	Nil	Nil	3,000	

Exemptions on lifetime gifts example 2

Activity

Annabel made the following lifetime gifts:

£	Donee and details	Date
240	Christmas present to her friend	28/11/18
16,000	Wedding present to her son	5/07/19
15,000	Gift to her niece	20/09/19
285,000	Transfer to a trust	28/05/20
500,000	Gift of quoted shares to her husband	15/06/20

Calculate the chargeable amount for each of the gifts above.

Feedback

Annabel's gift to her husband is exempt as this is an inter-spouse transfer.

Annabel's Christmas gift to her friend is <£250 so qualifies for a small gift exemption.

Remaining gifts are set out below:

	PET	PET	CLT	
	05/07/19	20/09/19	28/05/20	
Tax year of gift	2019/20	2019/20	2020/21	
Transfer of value - £	16,000	15,000	285,000	As per question
Less marriage exemption	-5,000			Consider any marriage or small gift exemptions before using the annual exemptions.
Less annual exemption				
2020/21			-3,000	
2019/20	-3,000	Nil	Nil	Annual exemptions must be used on a chronological basis
2018/19	-3,000	Nil	N/A	
Chargeable amount	5,000	15,000	282,000	

3. Calculating IHT due on lifetime transfers example

To calculate any IHT due on a lifetime transfer if this arises in any given year (i.e. when the various exemptions are not enough to cover lifetime transfers fully), exemptions are first applied against the transfer of value to reduce the chargeable amount accordingly.

Where an individual makes a transfer to a trust the chargeable amount will be shown as either gross (where the trust pays any IHT due) or net (where the individual has agreed to pay any IHT due). This is because if the individual pays any IHT due then the transfer amount plus the IHT will have left the estate so together they represent the gross amount.

Transfers during an individual's lifetime can utilise the nil rate band available on the date of the transfer (see tables at the end of this section – and page 331 in the textbook for explanation of the nil rate band). This nil rate band is effectively shared for all transfers within a seven year period on a chronological basis and reduces the chargeable amount to arrive at the taxable amount to calculate any IHT due.

Rates of IHT during an individual's lifetime are 20% where the trust pays the IHT and 25% where the individual has agreed to pay the IHT. This difference in rates is due to the grossing up effect using the ratio 20/80 on the net gift.

Lifetime IHT is due for payment on the following basis:

- For transfers made from 6 April to 30 September payment is due on the following 30 April
- For transfers made from 1 October to 5 April payment is due at the end of the 6th month after the one in which the transfer was made.

The following activity illustrates how this computation works in practice:

Activity

Dean made a gift to a trust on 27 July 2020 for £360,000. This is Dean's only lifetime gift.

Calculate the amount of lifetime IHT due on the gift to the trust and state the gross amount of the gift to carry forward. Based on the assumption that:

- A) The trustees agree to pay any IHT due
- B) Dean has agreed to pay any IHT due.

For both cases state when any IHT is due for payment.

Feedback

	A)		B)	
	Trustees pay IHT		Dean pays IHT	
	CLT		CLT	
	27/07/20		27/07/20	
Tax year of gift	2020/21		2020/21	
Transfer of value - £	360,000		360,000	As per question
Less annual exemption				
2020/21	-3,000		-3,000	
2019/20	-3,000		-3,000	
Chargeable amount (Gross)	354,000	(Net)	354,000	If Dean pays IHT then the tax will have left his estate too hence why the chargeable amount is net at this point.
Nil rate band at date of gift				
(2020/21)	-325,000		-325,000	
Taxable amount	29,000		29,000	
IHT payable @20%	5,800	@25%	7,250	A higher rate is used when donor pays the IHT
Gross chargeable amount c/f	354,000		361,250	(354,000+7,250 IHT)
Paid by	Trustees		Dean	
Date IHT is due	30/04/21		30/04/21	

4. 7 year cumulation period example

As explained above, the 7 year cumulation period is where the nil rate band is shared with all transfers that take place within a 7 year period. It effectively means looking back 7 years from the date that the current transfer took place to reduce the nil rate band by all the previous transfers that occurred in the last 7 years. Early IHT planning and advice will make best use of the 7 cumulation period so the individual gifts their assets over a long term with the view of reducing any lifetime IHT due or when the individual dies.

The activity below demonstrates the effect of the 7 year cumulation.

Activity

Andrew made the following lifetime gifts:

£	Donee	Date
170,000	Trust	20/06/14
153,000	Gift to his son	18/07/14
185,000	Trust	09/07/15
265,000	Trust	15/12/20

IHT liabilities were settled by the trustees for the first two trust gifts and Andrew paid the IHT on the last gift.

Calculate any IHT due on Andrew's lifetime transfers and show the gross chargeable amount carried forward. State who should pay any IHT on each gift and the due date of payment.

Feedback

	CLT	PET	CLT	CLT	
	20/06/14	18/07/14	09/07/15	15/12/20	
Tax year of gift	2014/15	2014/15	2015/16	2020/21	
Transfer of value - £	170,000	153,000	185,000	265,000	As per question
Less annual exemption					
2014/15	-3,000	Nil			Exemption for current year and preceding year
2013/14	-3,000	Nil			
2015/16			-3,000		
2014/15			Nil		
2020/21				-3,000	
2019/20	-			-3,000	
Chargeable amount	164,000 gross	153,000	182,000 gross	259,000 net	
Nil rate band at date of gift					
2014/15	325,000	No lifetime tax as a PET			Refer to tax tables
2015/16			325,000		Refer to tax tables
2020/21				325,000	Refer to tax tables
Less gross chargeable amounts 7 years before gift					
20/06/07 to 20/06/14	Nil				Look back 7 years from date of gift
Ignore PET					
09/07/08 to 09/07/15			-164,000		
15/12/13 to 15/12/20				-346,000	Include 164,000+ 182,000
Nil rate band available	325,000		161,000	Nil	
Taxable amount	Nil		21,000	259,000	
			@20%	@25%	
IHT payable	0		4,200	64,750	A higher rate is used when donor pays the IHT
Gross chargeable amount c/f	164,000	153,000	182,000	323,750	(259,000 + 64,750 IHT)

Paid by	N/A		Trustees	Andrew	
Date IHT is due	N/A		30/04/16	30/06/21	

There is no IHT due on the PET during Andrew's lifetime.

5. Death tax payable on lifetime gifts example

In the previous examples IHT has been calculated on lifetime transfers when the individual is still alive. This example considers IHT due on lifetime transfers as part of IHT due when the individual dies. PET's become chargeable for the first time if the individual has not survived for seven years or more after the transfer took place.

When calculating IHT the nil rate band at the date of death is available to reduce the chargeable amount using the same 7 year cumulation basis as explained in the example in section 4 above.

Depending on how long the individual has survived after the transfer took place taper relief is available to reduce any IHT due on the lifetime transfer at death. See the tables at the end of this section for the appropriate rates to use.

The following example illustrates this IHT computation due on death:

Activity

Lucia made the following lifetime transfers:

£	Donee	Date
75,000	Lucia's daughter	15/07/12
115,000	Lucia's son	20/11/14
240,000	Lucia's daughter	29/04/15

Lucia died on 15 June 2020.

Calculate any IHT due on Lucia's lifetime transfers and as a result of her death on 15 June 2020. State who should pay the IHT arising and the due date of payment.

Feedback

As the first PET of £75,000 is more than 7 years before Lucia's death it is completely exempt from IHT. The other two gifts are PET's so no lifetime IHT is payable. Both gifts are within 7 years of death however, so are chargeable to IHT.

	PET	PET	PET	
	15/07/12	20/11/14	29/04/15	
Tax year of gift	2012/13	2014/15	2015/16	
Transfer of value - £	75,000	115,000	240,000	As per question
Less annual exemption				
2012/13	-3,000			Exemption for current year and preceding year
2011/12	-3,000			
2014/15		-3,000		
2013/14		-3,000		
2015/16			-3,000	
2014/15	-		0	Already used on PET occurring in year
Chargeable amount	69,000	109,000	237,000	
IHT payable	0	0	0	All PET's so nil
Gross chargeable amount c/f	69,000	109,000	237,000	

Lifetime gifts are all PET's so there is no lifetime IHT due. Gross chargeable amounts are needed at the date of the gift to carry forward to the calculations of IHT on 15 June 2020, the date of death. There will be no IHT due on death from the PET made on 15th July 2012 as it is more than 7 years before Lucia's death on 15th June 2020.

IHT due on death - Date of death – 15 June 2020 (7 years before – 15 June 2013)

	PET	PET	
	20/11/14	29/04/15	
Gross chargeable amount b/f	109,000	237,000	GCT per lifetime workings
Nil rate band at date of death	325,000	325,000	
Less gross chargeable amounts <7 years before date of gift			
20/11/07 to 20/11/14	Nil*		*Nil as PET 15/7/12 is exempt
29/04/08 to 29/04/15		-109,000	Transfer on 20/11/14 is within 7 years
Nil rate band available	325,000	216,000	
Taxable amount	Nil	21,000	
IHT payable @40%		8,400	IHT at death is 40%
Less taper relief			
29/04/15 to 15/06/20 = 5-6 years before death		-5,040	(5-6 years is a reduction of 24% x taxable amount of £21,000 - see tax tables)
Less IHT paid during lifetime		Nil	
IHT payable on death	Nil	3,360	(Taxable amount 21,000 x 16%)
Paid by		Daughter	
Date IHT is due		31/12/20	6 months after death to the end of

			the month.
--	--	--	------------

As demonstrated above it is only the third PET that becomes chargeable at death, as the first PET was more than 7 years before death and the second PET was covered by the nil rate band. Lucia's daughter as donee of the third PET is liable for the IHT due.

6. IHT payable on the estate example

This example demonstrates how IHT is calculated on an individual's estate following their death using the main IHT death rate of 40% where the individual makes lifetime transfers and where they do not. The 7 year cumulation effect is also demonstrated in part B.

It is worth noting here that to arrive at the gross chargeable estate the total value of an individual's assets are added together less any liabilities and less any reasonable funeral expenses. Loans and repayment mortgages are also deducted from the asset total to arrive at the gross chargeable estate total. Endowment mortgages are interest only and will have a mandatory life insurance policy that pays off the mortgage on the death of the mortgage holder so are not allowed as a liability against the estate of the individual.

Activity

Stephen died on 18 November 2020. He left his gross chargeable estate of £410,000 to his cousin George.

- A) Calculate any IHT due on Stephen's estate assuming he made no lifetime transfers and as a result of his death on 18 November 2020.
- B) Calculate any IHT if Stephen had gross chargeable transfers of £125,000 within 7 years prior to his death.

Feedback

A) No lifetime transfers

	£	£	
Gross chargeable estate value		410,000	
Nil rate band at death	325,000		Per tax tables
Less CGT's in 7 years before death	Nil		
Nil rate band available		325,000	
Taxable amount		85,000	
IHT due on death @ 40%		34,000	

B) Lifetime transfer of £125,000

	£	£	
Gross chargeable estate value		410,000	
Nil rate band at death	325,000		Per tax tables
Less CGT's in 7 years before death	-125,000		
Nil rate band available		200,000	
Taxable amount		210,000	
IHT due on death @ 40%		84,000	

Appendix: 2020/21 IHT Tax Tables

Inheritance tax taper relief (Gifts within seven years of death)			
Number of years between gift and death		Percentage reduction in tax charge from full death rates of 40%	IHT Tax Rate
More than	Not more than		
0	3	0	40%
3	4	8%	32%
4	5	16%	24%
5	6	24%	16%
6	7	32%	8%
7		0%	0%

Exempted gifts:

Annual exemption

An annual exemption of £3,000 is available in each tax year (6 April to 5 April). Any unused annual exemption can be carried forward to the next year - for one year only.

Marriage exemption

£5,000 exemption for a child

£2,500 exemption for a grandchild or great grandchild

£1,000 exemption for any other wedding

For the exemption to apply the wedding must actually take place

Small gift exemption

A small gift exemption of up to £250 per person for each tax year applies provided there are no other exemptions for the same person.

IHT rate on lifetime transfers

If trust pays the tax – 20%

If donor pays the tax - 25%

Main IHT rate – 40%

Reduced rate – 36% (If at least 10% of the net estate is left to a charity)

Exemptions when passing on a home

Tax-free threshold of £325,000 increases by £175,000 to £500,000 if the donee owns part or all of their own home and pass it on to their direct descendants (children or grandchildren) for estates worth less than £2,000,000.

Properties worth more than £2,000,000, when sold, are subject to a claw-back at the rate of £1 for every £2 the home is sold over £2,000,000, back to the standard £325,000 threshold.

Inheritance Tax thresholds - from 18 March 1986 to 5 April 2021

From	To	Threshold/nil rate band
6 April 2009	5 April 2021	£325,000
6 April 2008	5 April 2009	£312,000
6 April 2007	5 April 2008	£300,000
6 April 2006	5 April 2007	£285,000
6 April 2005	5 April 2006	£275,000
6 April 2004	5 April 2005	£263,000
6 April 2003	5 April 2004	£255,000
6 April 2002	5 April 2003	£250,000
6 April 2001	5 April 2002	£242,000
6 April 2000	5 April 2001	£234,000
6 April 1999	5 April 2000	£231,000
6 April 1998	5 April 1999	£223,000
6 April 1997	5 April 1998	£215,000
6 April 1996	5 April 1997	£200,000
6 April 1995	5 April 1996	£154,000
10 March 1992	5 April 1995	£150,000
6 April 1991	9 March 1992	£140,000
6 April 1990	5 April 1991	£128,000
6 April 1989	5 April 1990	£118,000
15 March 1988	5 April 1989	£110,000
17 March 1987	14 March 1988	£90,000
18 March 1986	16 March 1987	£71,000