FIRST FINANCIAL

Inheritance Tax

Creating Wealth

Protecting Assets ...

Inheritance tax (IHT) was once seen as a tax on the wealthy, but with the average house in the UK now worth nearly £180,000, IHT is now a concern even if you are just a homeowner with modest savings.

Without the right planning, IHT could substantially reduce the value of the estate that you want to leave to your family. Fortunately, it is relatively easy to take some measures to mitigate IHT, particularly if you decide to take action early enough.

The 2007 Pre-Budget Report helped couples to maximise the use of their nil rate bands and created new planning opportunities. This followed major changes to the tax treatment of trusts in 2006.

How IHT is calculated.

IHT is primarily a tax on an individual's estate on death. When someone dies, IHT is charged on the assets that pass on death. It is also charged on any gifts made in the seven years up to the death. The tax rate is 40%. This is charged on the value of assets above a nil rate band, which in the current tax year 2008/09 is £312,000. If the individual made gifts in the seven years before death, the nil rate band is first set against these gifts, starting with the earliest.

For example, John died on 11 April 2008 with an estate of £800,000 consisting of his house and savings. In the last five years, he had given his children £100,000 in cash. At his death, the tax would be calculated as follows. First, £100,000 of the £312,000 nil rate band would be set against the gifts. The rest of the nil rate band (£212,000) would be set against the estate of £800,000 John left at death. Then the 40% tax rate would be applied to the balance of his estate. The tax would be £235,200.

In his 2007 Pre-Budget Report the Chancellor announced a change in the IHT rules which meant that the nil rate band – currently £312,000 per individual –is now transferable. The estate of a surviving spouse or civil partner is able to benefit from any unused inheritance tax nil rate band of their deceased spouse or partner. This applies on the death of a surviving spouse or partner after 8 October 2007, regardless of when the first death occurred.

The amount of the nil rate band available for transfer will be based on the proportion of the nil rate band that was unused when the first spouse or partner died. The unused proportion will be applied to the amount of the nil rate band in force at the date of the surviving spouse or partner's death.

For example, Robert dies today leaving his children £104,000 (i.e. one-third of the current nil rate band) with the rest of his estate passing to his wife, Paula. On Paula’s subsequent death, her nil rate band will then be increased by two-thirds. So, if the nil rate band at the time of Paula's death is £360,000, she will be able to leave £600,000 free of inheritance tax, i.e. £360,000 plus £240,000 (two-thirds of £360,000).

If a person marries more than once, the nil rate band of the survivor can only be increased by a maximum of 100%.

Any gifts in excess of the nil rate band in the seven years before death are charged at a reduced rate of IHT provided they were made more than three years before the death.

Some gifts are chargeable to inheritance tax at the time they are made. The main instances are transfers to most types of trust. This tax treatment of a wide range of trusts was introduced in the Finance Act 2006. These lifetime gifts are taxed at 20%, but only to the extent that the gift, added to all other chargeable gifts in the previous seven years, exceeds the nil rate band. There may also be periodic charges broadly every ten years and also exit charges when assets are passed out of a trust. These may be up to 6% of the value of the trust over and above the nil rate band at the time.