Inheritance tax

The rules, rates and allowances

Please read the important information

Smith & Williamson

What is Inheritance Tax?

Inheritance Tax is a tax payable when assets or money are passed to someone else. It is most commonly paid when your estate passes to other people after you die. Your estate is the combination of your worldwide property, savings and investments and other assets. Not everybody leaves behind an Inheritance Tax bill – in this guide we explain why.

How much is Inheritance Tax?

Inheritance Tax is usually charged at 40% on any part of your estate valued above the personal allowance (also called the nil rate band – see page 4). This drops to 36% if you give away at least 10% of your 'net' estate to charity (this is the value of your estate minus the nil rate band).

When is it paid?

The executors of your estate (as appointed in your Will) are responsible for valuing your estate and completing an Inheritance Tax return when you die. They must also pay the Inheritance Tax bill within six months of your death, otherwise probate (or 'confirmation' in Scotland) will not be granted. The rest of your assets cannot be distributed in line with your Will until probate is granted.

Inheritance Tax can also be payable on gifts made during your lifetime if you give away more than your nil rate band.

Your allowances

Everybody has a personal allowance for Inheritance Tax – this is called the nil rate band. Inheritance Tax only applies to the part of your estate valued above the nil rate band. This is why many people don't leave behind an Inheritance Tax bill when they die.

How much is the nil rate band?

The nil rate band is currently £325,000 per person and will remain at this amount until April 2026. However, your nil rate band may be reduced by any gifts you made in the seven years before your death.

The residence nil rate band

The residence nil rate band is an allowance for passing on the family home that was introduced in April 2017. It only applies to the family home (not a second home or buy-to-let property) and can only be used when passing on assets to direct descendants.

The residence nil rate band currently stands at £175,000 and will remain at that level until April 2026. The allowance is tapered down for people with larger estates – it reduces by £1 for every £2 that your estate is valued over the £2 million mark.

Allowances can be transferred between spouses

Both the nil rate band and the residence nil rate band can be transferred between married couples and civil partners when one spouse dies, regardless of how long ago this happened. Any individual can have a maximum of two nil rate bands and two residence nil rate bands. However, these can be transferred from multiple deceased spouses for people who have had several marriages or civil partnerships.

Both allowances are transferred as percentages, rather than explicit amounts of money. These rules can be very complex and you might need to take action to benefit from them, so you should consider speaking to a financial planner if you'd like to know more.

An Inheritance Tax bill – two examples

These two example bills demonstrate how Inheritance Tax works in practice. The first person has a single nil rate band, whereas the second person received a second nil rate band from their partner after they died.

Assets	Example one (one nil rate band)	Example two (two nil rate bands)
Family home	£400,000	£800,000
Car	£50,000	£20,000
ISAs	£110,000	£200,000
Cash savings	£250,000	£630,000
Jewellery and other assets	£175,000	£300,000
Total estate value	**£985,000**	**£1,950,000**
Less nil rate band(s)	-£325,000	-£650,000
Plus gifts made within the last seven years	£15,000	£50,000
Less residence nil rate band(s)	-£175,000	£350,000
Estate value to be charged 40% Inheritance Tax	£500,000	£1 million
Total Inheritance Tax bill	**£200,000**	**£400,000**

Important information

Examples of how tax or tax relief may apply are based on our understanding of current tax legislation. Whether any tax will be payable, at what level it is charged and whether you qualify for tax relief (if applicable) will depend on individual circumstances and may be subject to change in the future.

Will you leave behind an Inheritance Tax bill?

A financial planner can forecast your future finances to calculate whether there is likely to be any Inheritance Tax to pay when you die. If you know you're going to leave behind an Inheritance Tax bill, you can do more to plan ahead – whether that means spending more or making provisions to pay the future bill.

How does it work?

A financial planner can use cashflow modelling to forecast your future finances. This involves taking details of your current finances – your savings, investments, income and outgoings –and your plans for the future. Using powerful cashflow modelling software, a financial planner can analyse this information and create a long-term projection of your future finances.

They could also stress test different scenarios. For example, they could show you how your finances might be affected if you spent or gave away more money, the stock market fell or you had to go into care unexpectedly.

More freedom

Many people say that seeing what their future finances could look like gives them more freedom to enjoy their money. Armed with the knowledge that there should be plenty of money left when they die, they could start spending or giving away more now.

Avoiding a catch 22 situation

If you leave behind an Inheritance Tax bill, your assets can't be distributed in line with your Will until the bill has been settled. This can potentially create a catch 22 situation – the tax needs to be paid but the money from the estate can't be used to pay it.

Your executors may need to find the cash to pay the bill themselves – but of course this isn't always possible, and it can create more stress at what is already likely to be a difficult time. Knowing that you are likely to leave behind an Inheritance Tax bill gives you the opportunity to make provisions towards paying it.

Reducing or managing an Inheritance Tax bill

There are several ways to manage or reduce an Inheritance Tax bill. This is known as estate planning. Spending or giving away your assets is the simplest form – but there are many other options.

Making gifts

Gifting is often the most straightforward way to reduce a potential Inheritance Tax bill. Giving away money or assets will reduce the value of your estate, which could therefore reduce the size of your eventual Inheritance Tax bill. Gifts have different Inheritance Tax treatments depending on the value of the gift, when it was made and who it was given to.

Tax-free gifts

Certain gifts leave your estate immediately after being made, and are therefore free from Inheritance Tax:

- Gifts to your husband, wife or civil partner (as long as the UK is their permanent home)
- Gifts up to the value of £3,000 a year (your annual gifting allowance). The £3,000 can be split between as many people as you like, and if you don't use it you can carry it forward one year for a maximum allowance of £6,000
- Small gifts of up to £250. You can make as many of these gifts as you like but they can be no more than £250 per person
- Regular gifts out of excess income, as long as they won't affect your normal lifestyle
- Gifts to charities, museums, universities, sports clubs and some political parties
- Gifts of up to £5,000 to your child when they get married (or £2,500 to your grandchild)

The seven-year rule

Most gifts that are not immediately tax-free are considered potentially exempt. You need to survive for a minimum of seven years before these gifts are free from tax and leave your estate completely.

If you die within seven years of making a potentially exempt gift it will reduce the nil rate band available on your death, meaning there may effectively be Inheritance Tax to pay on it. However, if the value of your gifts is higher than your available nil rate band then the recipient of the gift could benefit from taper relief. This reduces the amount of Inheritance Tax over the seven years:

How long ago was the gift made?	How much is the Inheritance Tax reduced?
0-3 years	No reduction
3-4 years	20%
4-5 years	40%
5-6 years	60%
6-7 years	80%
More than 7 years	No tax to pay

Making gifts in trust

Trusts make it possible to give gifts to others while keeping control over the money. Usually when you set up a trust you can choose who receives the gift, when they receive it and what they can use it for. Many people make gifts in trust when the beneficiary is:

- Too young or inexperienced to look after the money
- In ill health or has certain disabilities
- Going through divorce or bankruptcy proceedings

You can also use certain trusts to make a gift while still benefiting from the money. For example, you could give away an investment while keeping any income it pays, or keep an investment while giving away its growth.

Claiming Business Relief*

Under Business Relief rules you may be able to reduce the value of your Inheritance Tax bill by owning or investing in a business.

You can claim Business Relief on:

- A business or interest in a business (including a sole trade and partnership)
- Land, buildings or machinery owned by a partner or controlling shareholder of a business
- Unquoted shares such as those listed on the Alternative Investment Market (AIM)

You will need to own the assets for at least two years before you can claim Business Relief on them.

Some assets become completely free from Inheritance Tax under these rules, whereas others only receive 50% relief – and there are also several exceptions. The rules can be complex, and investing in smaller companies can be higher risk, so if you are interested in Business Relief you should consider speaking to a financial planner.

Setting up life insurance

One of the simplest ways to manage Inheritance Tax is to take out a life insurance policy that pays a lump sum into a trust for your beneficiaries' benefit when you die. The money will remain outside your estate and can then be used to settle your Inheritance Tax bill. This can help to avoid a difficult situation where your beneficiaries will need to find the cash to settle your bill from elsewhere.

There are different types of life insurance but one of the simplest is a 'guaranteed' policy. With this type of policy the premiums are fixed for the rest of your life, and your beneficiaries are guaranteed a pre-agreed lump sum when you die.

You should bear in mind that an insurance policy will end if you do not make payments and there will be no cash value unless a valid claim is made.

Important information

*There is a liquidity risk with Business Relief investments: investors may have difficulties selling their investment. Investments in unquoted and smaller companies may fail and you, or your beneficiaries, may not receive back what you put in. These investments may lose their tax status through decisions made by the investment manager or through a change in legislation. Business relief qualifying status is assessed on death and cannot be guaranteed.

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