Inheritance Tax Guide

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The “Problem”

Inheritance Tax (‘IHT’) remains the most contentious of taxes – both politically and morally. Where it is payable it often involves substantial sums. In recent years more families than ever before are getting caught in the IHT net.

People have very different views of IHT and its fairness and how actively it should be avoided. Most people, in our experience, have little appetite for having a large sum deducted from their estate in favour of the government, especially at a time when government finances are in such a dire straight. Why pay tax to a government which has shown little evidence of spending the money wisely?

However, many people are also wary of leaving sizeable sums to beneficiaries, who have not earned the money themselves and who may be vulnerable to receiving large amounts of wealth in the future. This can be dealt with quite easily.

The reason why there are more families being ‘caught in the net’ is largely down to a combination of the freezing of the IHT Nil Rate Band and the recent escalation in property and other asset values.

The IHT Nil Rate Band

The Inheritance Tax (IHT) nil-rate band in the UK has been frozen at £325,000 per individual since 2009, with no increases despite inflation and rising property values. For couples, this band doubles to £650,000. The residence nil-rate band, an additional allowance for property passed to direct descendants, remains at £175,000, potentially allowing up to £1 million to pass tax-free for married couples or civil partners under qualifying conditions.

In the Autumn Budget 2024, the freeze on these thresholds was extended further from 2028 to 2030. This prolonged freeze amplifies the effect of fiscal drag, whereby inflation and rising estate values result in more estates becoming subject to IHT. Consequently, the number of families paying IHT is expected to increase significantly, despite the lack of direct rate changes

Property and Asset Values

The frozen allowance is just one side of the equation, rising wealth is the other side. A frozen allowance coupled with increasing asset prices is a potent combination. An estate worth £650,000 in 2009 could easily be worth £1 million today even at modest rates of asset growth.

Between 2009 and 2024, the UK stock market and property market have shown significant growth, though with notable fluctuations. The FTSE 100 index has experienced moderate gains in recent years, rising approximately 10% from 2014 to 2024, following a more robust 40% increase from 2009 to 2014. This reflects slower growth compared to the 2009-2020 period when the market grew by about 53%.

UK property prices, on the other hand, have seen substantial increases since 2009. By 2024, average property prices are approximately 70-80% higher compared to 2009, reflecting a continued upward trend despite economic challenges such as rising mortgage rates and inflation. From 2020 to 2024, price growth has slowed somewhat but remains consistent, driven by regional demand and constrained supply.

In 2009, a couple's property valued at £600,000, combined with other assets worth £200,000, totaled £800,000. Their IHT liability, assuming no residence nil-rate band (RNRB), was £60,000 (40% of the £150,000 exceeding their combined £650,000 nil-rate band).

By 2017, property inflation raised their property's value to £850,000, and other assets grew to £350,000, totaling £1.2 million. After introducing the RNRB, their liability was £140,000, an increase of £80,000.

In 2024, property prices have continued rising, and using average trends, the property could now be valued at £1.1 million, with other assets rising to £450,000, totaling £1.55 million. Despite allowances, including the frozen nil-rate band and the RNRB of £175,000, their estate exceeds the tax-free threshold by £725,000. This generates an IHT liability of £290,000, nearly five times the 2009 liability.

The Residence Nil Rate Band

As of 2024, the Residence Nil Rate Band (RNRB), introduced on 6th April 2017, provides an additional allowance of £175,000, specifically applicable to residential property passed to direct descendants.

This supplementary allowance is in addition to the standard nil-rate band of £325,000, helping qualifying estates potentially shield up to £500,000 (or £1 million for couples) from inheritance tax.

There are several things to note about this new Residence Nil Rate Band, including:

- This can be only used where residential properties (e.g. buy-to-let properties are excluded) are left to direct descendants (e.g. children)
- The allowance is progressively withdrawn once a joint estate, with the inclusion of their main residence, is worth £2,000,000 or more. The withdrawal is at the rate of £1 for every £2 over the £2,000,000 limit.

It is very important to understand there are complexities involved. The new rules are not as simple as they may appear.

However, on balance this allowance may help in many cases alleviate some of the additional IHT liability that has been building across the UK in recent years.

The IHT amounts collected increase

Even allowing for the benefit of the new Residence Nil Rate Band, the two effects of a frozen allowance and increasing asset values, described above, combine to bring more and more people into the position where IHT is a reality Where there is a liability the percentage tax payable escalates the higher the Estate value. The disproportionate effect is important. Take the following numbers as an example of how the tax bites ever harder on the scale of wealth:

Estate Value (£)	Tax Payable (£)	Tax as a % of Wealth (%)
1,000,000	0	0
1,350,000	200,000	13.33
2,000,000	400,000	20.0
3,000,000	1,070,000	35.67

The figures make assumptions about how much of the Residence Nil Rate Band is available, and these figures could vary depending on individual circumstances.

However, in general terms the IHT, both in pounds payable and percentage, continues to increase as the estate value increases.

For many individuals the ‘problem’ is exasperated by a feeling of being powerless to do anything about it. The impression is that to deal with the IHT there have to be major sacrifices made in the lifetime of the individual whose estate will be taxed later down the line (if no action is taken). This is further complicated by the obvious point that most people don’t know when they will die.

There is good anecdotal evidence to suggest that if people knew when they were going to die they would plan their finances down to a tee mixing their lifetime requirement against their IHT reduction; but this doesn’t happen because of this unknown (which in every other respect is a good thing).

In Summary

- IHT is a tax which is affecting more and more people, families and estates
- The IHT amount hits ever harder as asset values increase above the thresholds
- It is a tax which most people want to avoid paying
- However, in many cases people are wary of what they leave, to whom and when and want control of this
- There is a feeling that this is too difficult a problem to solve in a lifetime
- And that the problem requires too much “lifetime” sacrifice

The Solutions

Although it is often perceived that IHT planning involves the sacrifice of lifetime benefit (i.e. you have to give everything away to reduce your future estate value and estate IHT liability) this is exactly that: a perception.

Essentially, for the majority of people there are a handful of approaches that can be taken to mitigate a future IHT liability:

1. Ignore it – allowing the "what will be, will be" approach to win the day. If there is tax to pay later on so be it.
2. Spend enough money so that nothing is left; which may be more difficult said than done!
3. Wanting to do something but feeling like it is too tough a task or requires too much sacrifice or cost.
4. Wanting to do something and creating a structured plan and approach to tackle the 'problem'.

There are many ways IHT can be reduced, offset or eradicated altogether and many of these do not have to involve a reduction in lifetime benefit.

However, having made the statement above, the flip side is that there are many people who can reduce their estate by distributing their assets in their lifetime and who can afford to do so.

It is a case of determining what can be done and how much any particular approach will cost (where the cost may be measured in other ways above and beyond a monetary cost).

The solutions available are likely therefore, to represent different opportunities or attractions to different people, depending on their circumstances.

We present below a series of possible methods of tackling the IHT liability. In every case we present a top-level explanation, which is not meant to act as anything other than an indication of what may be achievable – nothing here is intended to represent a detailed analysis, which can only come from an individual consultation and advice.

It is likely in any IHT planning situation that a combination of the individual solutions will be used to create an overall plan to reduce or totally mitigate an IHT liability.

Gifting

Naturally the most effective solution is to ensure that your estate value on death is equal to or less than the value of your Nil Rate Band, the allowance you have where no IHT is payable (£325,000 for an individual/£650,000 for a couple or £500,000/£1,000,000 if you can fully use the Residence Nil Rate Band.

In this respect distributing wealth prior to death is highly effective. If you have an estate value which is £200,000 more than the IHT allowance then gifting £200,000 is going to bring your estate below the IHT allowance and save your beneficiaries £80,000 in tax. If you can do this without affecting your lifetime position then this is a clear and easy step to take.

However, this does have some drawbacks:

- Most notably that gifts are not always outside of your estate from day one. Yes some gifts are immediately effective (for example you can gift as much money as you like from your yearly income, providing it does not reduce your standard of living) but most larger gifts are not.
- You will also need to live 7 years for gifts to clear out of your estate; even then the type and the extent of the gift(s) you make are important because some gifts are known as Potentially Exempt Transfers (PETs) and some Chargeable Lifetime Transfers (CLTs).
- These can sometimes have tax charges in your lifetime – if they are above a certain size. Although it may seem simple to just gift your money away, it is not; you need to do so very carefully and with a clear structure if you are to achieve an IHT saving.
- In addition many people don't want to gift their money (assets/wealth) away because they do not know exactly how long they will live or how much money they may need in their lifetime; especially where there is a major concern around care costs.
- Most people will not need care in their lifetimes, but enough will to make it a serious threat and the costs of care are now so high, with an emphasis on individual payment of these costs (and there is no insurance available at this time) that this threat often causes people to hoard their assets against this eventuality.
- Finally gifting obviously comes with some threat or concern over the beneficiary's position – "if I give Johnny £100,000 and he is bankrupted or divorced, might my wealth end up outside of my family or bloodline?" The answer is, yes it might. Gifting can therefore be an attractive IHT reducer but it may end up robbing Peter (the taxman) to pay Paul (an ex-spouse of a daughter for example).

The ‘7 Year Rule’

Gifts you make to individuals will be exempt from Inheritance Tax as long as you live for 7 years after making the gift. Gifts of this sort are called 'Potentially Exempt Transfers' (PETs).

To make sure the gift qualifies as a PET you must ensure you do not retain any interest in it.

If you die within 7 years and the total value of gifts you made is less than the Inheritance Tax threshold, then the value of the gifts is added to your estate and any tax due is paid out of the estate.

However, if you die within 7 years of making a gift and the gift is valued at more than the Inheritance Tax threshold, Inheritance Tax will need to be paid on its value, either by the person receiving the gift or by the estate (the executors).

If you die between 3 and 7 years after making a gift, and the total value of gifts that you made is over the threshold, any Inheritance Tax due on the gift is reduced on a sliding scale. This is known as 'Taper Relief'. The gift itself has to be above the Nil Rate Band to qualify for this.

A good way to structure the gift to get immediate IHT-saving value is to combine the gift with a short-term decreasing life assurance policy (written in trust). For example, if you gift an asset worth £200,000 to save £80,000 in IHT, it will take 7 years before this £80,000 is outside of your estate. In this case you can put a life policy in place which pays out £80,000 in the first three years and then a smaller sum in years 4-7 (to match the IHT still liable in each year), so that the net effect is the £200,000 is effectively IHT free from day one.

Gifting is very effective but comes with some risks and potential complications, which is why gifting may work in conjunction with the next segment:

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Trusts

It is odd that many have a perception of trusts as complicated, costly and cumbersome; only for the rich. None of these are accurate descriptions of trusts.

There are many different types of trust with multiple ways of being used, so any short summary has to simply highlight the main points:

- Trusts are an excellent way to make gifts; rather than gifting money direct to beneficiaries. Assets can be gifted into trust, maintaining an element of control, flexibility and direction for the person(s) making the gift.
- They allow for money to be ring fenced from future taxes (including and most prevalently IHT) and possibly from being taken into account for future care fees assessments.
- They can be used to ensure that assets are kept within the family and/or the bloodline, protecting against bankruptcy or divorce of a beneficiary.
- They can help ensure assets are distributed quickly after death (see further comments at the end of this document).

Using Exemptions

There are various ways of gifting money without any recourse to a 7 year rule, these include gifts to charities, using the annual allowance of £3,000 (that every individual has to make gifts which are automatically exempt), gifts to children or grandchildren on marriage and, as described above, the rule that you can gift any amount you like 'out of normal income'.

Although these gifts can look peripheral and unlikely to make any significant difference in the big scheme of things, they can quickly add up. For parents who have two children who both marry within a 10-year period, it is possible the combined value of making regular gifts utilising the three exemptions mentioned above could be very close to £100,000, which could save £40,000 in IHT liability.

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Business Relief

Another exemption can be achieved via Business Relief (BR). BR is available for qualifying investments and assets and includes a reasonable list of suitable holdings, for example shareholdings in smaller companies listed on the AIM stock market, shares in a privately-owned business and holdings in agricultural. The relief is generally either 50% of the value of the holding or asset or 100% depending which category it falls into.

BR locks in after the asset has been owned for 2 years and then the relief is absolute, provided the assets are still held at the date of death.

Where the relief is 100% this means that the whole value is taken out of the estate after that period. For example, an investment into BR qualifying AIM shares will take the full value of that investment out of the estate after just 2 years. £100,000 placed in such investments reduce the IHT liability by £40,000 after 2 years.

Many people who have an IHT liability hold money in ISAs and in a lot of cases the value of these ISAs will be £100,000 +, the issue with ISAs is they have no IHT exemption. The whole ISA value will be entered into the calculation for IHT purposes. The comparison here with a BR qualifying investment portfolio is largely about risk because the tax advantages of such a portfolio are often comparable to ISA holdings and they offer IHT exemption. So, it is only the fact they are perceived to be higher risk that most IHT affected investors would hold money in ISAs.

Unlike gifting assets away, the BR schemes will typically keep the value available to the investor in their lifetime.

In reality the BR portfolio can be constructed in such a way that the risk is not increased too much, if at all. We would encourage anyone looking for IHT planning ideas to take a serious look at the BR possibilities.

This can be especially valuable to anyone looking to achieve a quick reduction in IHT, because of age or ill health or where all other avenues have been exhausted.

Life Assurance Solutions

Amongst all possible options, the life assurance solution is the one that often receives the least attention, because it is often assumed that it is expensive or prohibitive.

Ironically this is not the case at all. For a couple in their 60s or even 70s, for example, the cost of a joint life second death policy is remarkably low (in relative terms).

The way this solution works is that the potential IHT liability is assessed (for example £200,000) and a policy put in place with a life assurance amount equal to the IHT liability. In this example the sum assured would be £200,000. It is written on a joint life second death basis with the life assurance amount under a trust. Normally this will be set up on a 'whole of life' basis meaning it will run until the death of the second person.

Then the £200,000 will be paid out (when the second person dies), under the trust, to the trustees. The trustees will then use this money to settle the IHT.

The premiums paid come out of the normal expenditure rule or via the £3,000 per year annual exemption each individual has, so the premiums are outside of the IHT loop.

This is a neat, tidy way of insuring the IHT exposure and may act as a simple way of keeping the full value of an estate within the family, suiting many people's circumstances.

One of the more subtle aspects of this arrangement – and this applies to all trust arrangements – is that their mechanisms keeps assets outside of the estate, not only for IHT purposes but also for the purposes of probate. This means that the assets within the trust (or paid into the trust on death) can be distributed with immediate effect, there is no need to wait for probate. This can be very beneficial to the family and those responsible for the affairs of the family. It can also help beneficiaries.

Summary

Inheritance Tax is most commonly payable by beneficiaries after death; although it is not strictly a death tax anymore (IHT can be payable in a lifetime in some circumstances) this is when it will apply for the majority of people. Death is inevitable, therefore for anyone who has assets above the IHT threshold – IHT is inevitable, unless action is taken. We hope the solutions presented show that with sensible approaches and action, IHT can be reduced or avoided without too much difficulty.

There are many possible ways of dealing with this liability, and avoiding it. Just about any circumstance or requirement can be met. What is important is that you seek advice on your options.

The information in this guide contains details of tax rates, allowances and exemptions relating to Inheritance Tax Legislation, plus ideas about these may be managed or mitigated. All information and ideas presented are subject to the prevailing tax rules and will be dictated by personal circumstances. You should only use this guide as indicative of what may be the case or what you may be able to do. No action should be taken as a result of anything within this guide, you should always take appropriate regulated advice before proceeding to act in any way to deal with any possible IHT liability or requirement you have.

This publication is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The Financial Conduct Authority (FCA) does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. This publication represents our understanding of law and HM Revenue & Customs practice as at February 2020.

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The value of investments may go down as well as up and you may get back less than you invest.

This guide is for information purposes and does not constitute financial advice, which should be based on your individual circumstances.