INHERITANCE TAX, PART 2

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The second article in the series covers those aspects of inheritance tax that you will need to know, such as tax liability on lifetime transfers and death estates, and inheritance tax payments. *Read part 1 here*

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 those of you 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 first part of the article covered the scope of IHT, transfers of value, rates of tax and exemptions.

Tax liability on lifetime transfers

When calculating the tax liability on lifetime transfers there are three aspects that are a bit more difficult to understand, and can cause problems for students.

CLT preceded by a PET that becomes chargeable

The situation where a CLT is made before a PET is fairly straightforward, and has been covered in previous examples. However, where the sequence of gifts is reversed the IHT calculations are more complicated because the PET will use some or all of the nil rate band previously given to the CLT.

Example 1

Ali died on 3 March 2013. He had made the following lifetime gifts:

- 1 August 2010 – A gift of £360,000 to his son
- 21 November 2011 – A gift of £240,000 to a trust

These figures are after deducting available exemptions.

The nil rate band for the tax years 2010–11 and 2011–12 is £325,000.

IHT liabilities are as follows:

Lifetime transfers

1 August 2010	
Potentially exempt transfer	360,000
	_______
21 November 2011	

1 August 2010	
Chargeable transfer	240,000
	———

1 August 2012	
Potentially exempt transfer	360,000
	———
21 November 2011	
Chargeable transfer	240,000
	———

- No lifetime IHT is payable as the CLT is less than the nil rate band for 2011–12.

Additional liabilities arising on death

1 August 2010

Potentially exempt transfer	360,000
	———
IHT liability 325,000 at nil% 35,000 at 40%	 14,000
	———

21 November 2011

Chargeable transfer	240,000

IHT liability 240,000 at 40%	96,000
IHT already paid	(Nil)
Additional liability	96,000

- The nil rate band for 2012–13 of £325,000 has been fully utilised by the PET made on 1 August 2010.

Grossing up

In all the examples so far concerning a CLT the trust (the donee) has paid any lifetime IHT that has arisen. The loss to the donor's estate is therefore just the amount of the gift. However, the donor is primarily responsible for any lifetime IHT that arises on a CLT. In this case the loss to the donor's estate is both the amount of the gift and the related tax liability. To correctly calculate the amount of IHT payable it is therefore necessary to gross up the net gift.

Any available annual exemptions are deducted prior to grossing up, and it is only necessary to gross up the amount in excess of the nil rate band.

Example 2

On 17 June 2009 Annie made a gift of £406,000 to a trust. She paid the IHT arising from the gift.

Annie has not made any other gifts since 6 April 2008.

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

The lifetime IHT liability is calculated as follows:

	£	
Value transferred		406,000
Annual exemptions		
2009–10	3,000	

	£	
2008–09	3,000	
	______	
		(6,000)
		_______
Net chargeable transfer		400,000
IHT liability 325,000 at nil% 75,000 x 20/80		 18,750
		_______
Gross chargeable transfer		418,750
		_______

- The amount of lifetime IHT payable by Anne is £18,750. This figure can be checked by calculating the IHT on the gross chargeable transfer of £418,750:

IHT liability 325,000 at nil% 93,750 at 20%	 18,750
	______

Once the gross chargeable transfer has been calculated then this figure is used in all subsequent calculations. CLTs are never re-grossed up on death, even if the nil rate band is reallocated as a result of a PET becoming chargeable.

Example 3

Continuing with Example 2, assuming that Annie died on 12 March 2013.

Additional liability arising on death

17 June 2009

Gross chargeable transfer	418,750
IHT liability 325,000 at nil% 93,750 at 40%	 37,500
Taper relief – 20%	(7,500)
IHT already paid	30,000
	(18,750)
Additional liability	11,250

When an IHT question involves a CLT then make sure you know who is paying the IHT. Grossing up is not necessary if the trust (the donee) pays.

Seven-year cumulation period

As far as Paper F6 (UK) is concerned the most difficult aspect to grasp is the seven-year cumulation period.

What the seven-year cumulation period means is that when calculating the IHT on a lifetime transfer (either a PET becoming chargeable or a CLT) it is necessary to take account of any CLT made within the previous seven years despite it being made more than seven years before the date of the donor's death. Only CLTs have to be taken into account, as PETs made more than seven years before the date of death are completely exempt.

Example 4

Ja died on 18 March 2013 leaving an estate valued at £450,000. She had made the following lifetime gifts:

- 1 August 2004 – A gift of £200,000 to a trust
- 1 November 2010 – A gift of £280,000 to a trust

These figures are after deducting available exemptions. In each case the trust paid any IHT arising from the gift.

The nil rate band for the tax year 2004–05 is £263,000, and for the tax year 2010–11 it is £325,000.

IHT liabilities are as follows:

Lifetime transfers

1 August 2004

Chargeable transfer	200,000

- No lifetime IHT is payable as the CLT is less than the nil rate band for 2004–05.

1 November 2010

Chargeable transfer	280,000

IHT liability
  125,000 at nil%
  155,000 at 20%
	
	31,000

- The CLT made on 1 August 2004 is within seven years of 1 November 2010, so it utilises £200,000 of the nil rate band for 2010–11.

Additional liabilities arising on death

1 August 2004

Chargeable transfer	200,000

- There is no additional liability as this CLT was made more than seven years before the date of Ja’s death on 18 March 2013.

1 November 2010

Chargeable transfer	280,000
	———
IHT liability 125,000 at nil% 155,000 at 40%	 62,000
IHT already paid	(31,000)
	———
Additional liability	31,000
	———

- The CLT made on 1 August 2004 utilises £200,000 of the nil rate band for 2012–13 of £325,000.

Death estate

Chargeable estate	450,000
	———
IHT liability 45,000 at nil% 405,000 at 40%	 162,000
	———

- The CLT made on 1 August 2004 is not relevant when calculating the IHT on the death estate as it was made more than seven years before the date of Ja’s death on 18 March 2013.
- Therefore only the CLT made on 1 November 2010 is taken into account, and this utilises £280,000 of the nil rate band of £325,000.

Example 5

The same situation as in Example 4, except that on 1 November 2010 Ja made a gift of £280,000 to her daughter rather than to a trust.

IHT liabilities are as follows:

Lifetime transfers

1 August 2004	
Chargeable transfer	200,000
1 November 2010	
Potentially exempt transfer	280,000

Additional liabilities arising on death

1 August 2004	
Chargeable transfer	200,000
1 November 2010	
Potentially exempt transfer	280,000
IHT liability 125,000 at nil% 155,000 at 40%	 62,000
Death estate	

Chargeable estate	450,000
	_______
IHT liability	
45,000 at nil%	
405,000 at 40%	162,000
	_______

Advantages of lifetime transfers

Lifetime transfers are the easiest way for a person to reduce their potential IHT liability.

- A PET is completely exempt after seven years.
- A CLT will not incur any additional IHT liability after seven years.
- Even if the donor does not survive for seven years, taper relief will reduce the amount of IHT payable after three years.
- The value of PETs and CLTs is fixed at the time they are made, so it can be beneficial to make gifts of assets that are expected to increase in value such as property or shares.

Tax liability on death estate

Until now the examples have simply given a figure for the value of a person's estate. However, it may be necessary to calculate it.

A person's estate includes the value of everything which they own at the date of death such as property, shares, motor vehicles, cash and other investments. A person's estate also includes the proceeds from life assurance policies even though these proceeds will not be received until after the date of death. The actual market value of a life assurance policy at the date of death is irrelevant.

The following deductions are permitted:

- Funeral expenses
- Debts due by the deceased provided they were incurred for valuable consideration. Therefore, gambling debts cannot be deducted.
- Mortgages on property. This does not include endowment mortgages as these are repaid upon death by the life assurance element of the mortgage. Repayment mortgages and interest-only mortgages are deductible.

Example 6

Andy died on 31 December 2012. At the date of his death he owned the following assets:

- A main residence valued at £425,000. This had an outstanding interest-only mortgage of £180,000.
- Motor cars valued at £63,000.
- Ordinary shares in Herbert plc valued at £54,000.
- Building society deposits of £25,000.
- Investments in individual savings accounts valued at £22,000, savings certificates from the National Savings & Investments Bank valued at £19,000, and government stocks (gilts) valued at £34,000.
- A life assurance policy on his own life. On 31 December 2012 the policy had an open market value of £85,000, and proceeds of £100,000 were received following Andy's death.

On 31 December 2012 Andy owed £700 in respect of credit card debts, and he had also verbally promised to pay the £800 legal fee of a friend. The cost of his funeral amounted to £4,300.

	£	
Property	425,000	
Mortgage	(180,000)	
	________	
		245,000
Motor cars		63,000
Ordinary shares in Herbert plc		54,000
Building society deposits		25,000
Other investments (22,000 + 190,000 + 34,000)		75,000
Proceeds of life assurance policy		100,000
		________
		562,000
Credit card debts	700	

	£	
Funeral expenses	4,300	
	_____	
		(5,000)
		______
Chargeable estate		557,000
IHT liability 325,000 at nil% 232,000 at 40%		92,800
		______

- The promise to pay the friend's legal fee is not deductible as it is purely gratuitous (not made for valuable consideration).
- Unlike capital gains tax, there is no exemption for motor cars, individual savings accounts, saving certificates from the National Savings & Investments Bank or for government stocks.
- The IHT liability on the life assurance policy could have easily been avoided if the policy had been written into trust for the beneficiaries of Andy's estate. The proceeds would have then been paid direct to the beneficiaries, and not formed part of Andy's estate. However, this aspect is **not examinable** at Paper F6 (UK).

Payment of inheritance tax

Chargeable lifetime transfers

The donor is primarily responsible for any IHT that has to be paid in respect of a CLT. However, a question may state that the donee is to instead pay the IHT. Remember that grossing up is only necessary where the donor pays the tax.
The due date is the later of:

- 30 April following the end of the tax year in which the gift is made.
- Six months from the end of the month in which the gift is made.

Therefore, if a CLT is made between 6 April and 30 September in a tax year then any IHT will be due on the following 30 April. If a CLT is made between 1 October and 5 April in a tax year then any IHT will be due six months from the end of the month in which the gift is made.

The donee is always responsible for any additional IHT that becomes payable as a result of the death of the donor within seven years of making a CLT. The due date is six months after the end of the month in which the donor died.

Potentially exempt transfers

The donee is always responsible for any additional IHT that becomes payable as a result of the death of the donor within seven years of making a PET. The due date is six months after the end of the month in which the donor died.

Death estate

The personal representatives of the deceased’s estate are responsible for any IHT that is payable. The due date is six months after the end of the month in which death occurred. However, the personal representatives are required to pay the IHT when they deliver their account of the estate assets to HM Revenue and Customs, and this may be earlier than the due date.

Where part of the estate is left to a spouse then this part will be exempt and will not bear any of the IHT liability. Where a specific gift is left to a beneficiary then this gift will not normally bear any IHT. The IHT is therefore usually paid out of the non-exempt residue of the estate.

Example 7

Alfred died on 15 December 2012. He had made the following lifetime gifts:

- 20 November 2010 – A gift of £420,000 to a trust. Alfred paid the IHT arising from this gift
- 8 August 2011 – A gift of £360,000 to his son

These figures are after deducting available exemptions.

Alfred’s estate at 15 December 2012 was valued at £850,000. Under the terms of his will he left £250,000 to his wife, a specific legacy of £50,000 to his brother, and the residue of the estate to his children.

The nil rate band for the tax years 2010–11 and 2011–12 is £325,000.

IHT liabilities are as follows:

Lifetime transfers

20 November 2010

Net chargeable transfer	420,000
IHT liability	
325,000 at nil%	
95,000 x 20/80	23,750

	________

Gross chargeable transfer	443,750
	________

- The due date for the IHT liability of £23,750 payable by Alfred was 31 May 2011.

8 August 2011

Potentially exempt transfer	360,000
	________

- The PET is initially ignored.

Additional liabilities arising on death

20 November 2010

Gross chargeable transfer	443,750
	________
IHT liability 325,000 at nil% 118,750 at 40%	 47,500
IHT already paid	(23,750)
	________
Additional liability	23,750
	________

- The due date for the additional IHT liability of £23,750 payable by the trust is 30 June 2013.

8 August 2011

Potentially exempt transfer	360,000
	_______
IHT liability 360,000 at 40%	144,000
	_______

- The CLT made on 20 November 2010 has fully utilised the nil rate band.
- The due date for the IHT liability of £144,000 payable by Alfred's son is 30 June 2013.

Death estate

Value of estate	850,000
Spouse exemption	(250,000)
	_______
Chargeable estate	600,000
	_______
IHT liability 600,000 at 40%	240,000
	_______

- The due date for the IHT liability of £240,000 payable by the personal representatives of Alfred's estate is 30 June 2013.
- Alfred's wife will inherit £250,000, his brother will inherit £50,000, and the children will inherit the residue of £310,000 (850,000 – 250,000 – 50,000 – 240,000).

Exam standard question

The following is typical of an exam question that could be set on IHT at Paper F6 (UK).

Jing died on 21 January 2013. She had made the following lifetime gifts:

- 3 March 2005 – A gift of £126,000 to a trust
- 12 January 2008 – A gift of £40,000 to her husband
- 10 May 2009 – A gift of £200 to a nephew
- 23 June 2009 – A gift of £240,000 to her daughter
- 2 September 2009 – A gift of £300,000 to a trust

Jing paid any IHT arising from the gifts to the trusts.

Nil rate bands are as follows:

2004–05	263,000
2007–08	300,000
2009–10	325,000

Required

(a) State the advantages for inheritance tax purposes of making lifetime gifts of assets.

(3 marks)

(b) Calculate the inheritance tax that will be payable as a result of Jing's death.

(12 marks)

(15 marks)

(a)

1. After seven years of making the gift a PET will be completely exempt, while a CLT will not incur any additional IHT liability.
2. Even if the donor does not survive for seven years, taper relief will reduce the amount of IHT payable after three years.
3. The value of PETs and CLTs are fixed at the time they are made, so it can be beneficial to make gifts of assets that are expected to increase in value so that this increased value is not included in the death estate.

(b)

Jing – Inheritance tax computation

Lifetime transfers

3 March 2005

Value transferred		126,000
Annual exemptions		
2004–05	3,000	

2003–04	3,000	
	–––––	
		(6,000)
		–––––––
Chargeable transfer		120,000
		–––––––

12 January 2008

Exempt as a transfer to spouse.

10 May 2009

Exempt as a small gift under £250.

23 June 2009

Value transferred		240,000
Annual exemptions		
2009–10	3,000	
2007–08	3,000	
	–––––	
		(6,000)
		–––––––
Potentially exempt transfer		234,000
		–––––––

2 September 2009

Net chargeable transfer	300,000
IHT liability	
205,000 at nil%	
95,000 x 20/80	23,750
	________
Gross chargeable transfer	323,750
	________

Notes:

1. *No lifetime IHT is payable in respect of the CLT made on 3 March 2005 as it is less than the nil rate band for 2004–05.*
2. *The PET made on 23 June 2009 utilises the annual exemptions for 2009–10 and 2008–09, therefore there is no annual exemption left to use against the CLT made on 2 September 2009.*
3. *The CLT made on 3 March 2005 is within seven years of the CLT made on 2 September 2009, so it utilises £120,000 of the nil rate band for 2009–10.*

Additional liabilities arising on death

3 March 2005

Chargeable transfer	120,000
	________

23 June 2009

Potentially exempt transfer	234,000
	________
IHT liability	

205,000 at nil% 29,000 at 40%	 11,600
Taper relief reduction – 20%	(2,320)
	_______
	9,280
	_______

2 September 2009

Gross chargeable transfer	323,750
	________
IHT liability 323,750 at 40%	129,500
Taper relief reduction – 20%	(25,900)
	________
IHT already paid	103,600
	(23,750)
	________
Additional liability	79,850
	________

Notes:

1. *As regards the PET made on 23 June 2009, the seven year cumulative total is £120,000 so £205,000 (325,000 – 120,000) of the nil rate band for 2012–13 of £325,000 is available.*

2. *As regards the CLT made on 2 September 2009, the seven year cumulative total is £354,000 (120,000 + 234,000) so the nil rate band for 2012–13 has been fully utilised.*
3. *For the gifts on 23 June 2009 and 2 September 2009 the taper relief reduction is 20% as they were made between three and four years of the date of Jing's death.*

Written by a member of the Paper F6 examining team

INHERITANCE TAX – DETAILED EXAMPLE

The following example brings together most of the points covered in the IHT article. It is much longer than a typical exam question.

Jing died on 21 January 2013. She had made the following lifetime gifts:

- 3 March 2005 – A gift of £126,000 to a trust
- 8 August 2007 – A gift of £206,000 to her son
- 12 January 2008 – A gift of £40,000 to her husband
- 10 May 2009 – A gift of £200 to a nephew
- 23 June 2009 – A gift of £40,000 to her daughter when she got married
- 2 September 2009 – A gift of £300,000 to a trust

Jing paid any IHT arising from the gifts to the trusts.

At the date of her death Jing owned the following assets:

- A holiday cottage valued at £220,000. This had an outstanding endowment mortgage of £60,000.
- Units in the Global Trust, a unit trust, valued at £12,000.
- Cash deposits in individual savings accounts of £16,800.
- A motor car valued at £8,000.
- A life assurance policy on her own life. On 21 January 2013 the policy had an open market value of £45,000, and proceeds of £50,000 were received following Jing's death.

On 21 January 2013 Jing owed £3,600 in respect of a personal loan from a bank, and had gambling debts of £600. The cost of her funeral amounted to £3,200.

Under the terms of her will Jing left £100,000 to her husband, a specific legacy of £40,000 to her brother, and the residue of the estate to her children.

Nil rate bands are as follows:

2004–05	263,000
2007–08	300,000

2009–10	325,000

IHT liabilities are as follows:

Lifetime transfers

3 March 2005

	£	
Value transferred		126,000
Annual exemptions		
2004–05	3,000	
2003–04	3,000	
	_____	
		(6,000)
		_______
Chargeable transfer		120,000
		_______

- No lifetime IHT is payable as the CLT is less than the nil rate band for 2004–05.

8 August 2007

	£	
Value transferred		206,000
Annual exemptions		
2007–08	3,000	
2006–07	3,000	
	_____	
		(6,000)

	£	
		———
Potentially exempt transfer		200,000
		———

12 January 2008

Exempt as a transfer to spouse.

10 May 2009

Exempt as a small gift under £250.

23 June 2009

	£	
Value transferred		40,000
Marriage exemption	5,000	
Annual exemptions 2009–10 2008–09	 3,000 3,000	
	———	
		(11,000)
		———
Potentially exempt transfer		29,000
		———

2 September 2009

Net chargeable transfer	300,000
IHT liability	

205,000 at nil%	
95,000 x 20/80	23,750
	———
Gross chargeable transfer	323,750
	———

- The PET made on 23 June 2009 has utilised the annual exemptions for 2009–10 and 2008–09.
- The CLT made on 3 March 2005 is within seven years of 2 September 2009, so it utilises £120,000 of the nil rate band for 2009–10.
- The due date for the IHT liability of £23,750 payable by Jing was 30 April 2010.

Additional liabilities arising on death

3 March 2005

Chargeable transfer	120,000
	———

- This CLT was made more than seven years before the date of Jing's death on 21 January 2013.

8 August 2007

Potentially exempt transfer	200,000
	———

- The seven-year cumulative total is £320,000 (120,000 + 200,000), which is less than the nil rate band for 2012–13 of £325,000. No IHT is payable.

23 June 2009

Potentially exempt transfer	29,000

	______
IHT liability 5,000 at nil% 24,000 at 40%	 9,600
Taper relief reduction – 20%	(1,920)
	______
	7,680
	______

- The seven-year cumulative total is £320,000 so £5,000 (325,000 – 320,000) of the nil rate band for 2012-13 of £325,000 is available.
- The taper relief reduction is 20% as the gift to the daughter was made between three and four years of the date of Jing's death.
- The due date for the IHT liability of £7,680 payable by Jing's daughter is 31 July 2013.

2 September 2009

Gross chargeable transfer	323,750
	_______
IHT liability 323,750 at 40%	129,500
Taper relief reduction – 20%	(25,900)
	_______
	103,600
IHT already paid	(23,750)
	_______

Additional liability	79,850
	______

- The seven-year cumulative total is £349,000 (120,000 + 200,000 + 29,000) so the nil rate band for 2012-13 has been fully utilised.
- The taper relief reduction is 20% as the gift to the trust was made between three and four years of the date of Jing’s death.
- The due date for the IHT liability of £79,850 payable by the trust 31 July 2013.

Death estate

	£	
Property		220,000
Units in Global Trust		12,000
Individual savings accounts		16,800
Motor car		8,000
Proceeds of life assurance policy		50,000
		______
		306,800
Bank loan	3,600	
Funeral expenses	3,200	
	_____	
		(6,800)
		______
Value of estate		300,000

	£
Spouse exemption	(100,000)
	________
Chargeable estate	200,000
IHT liability 200,000 at 40%	80,000
	________

- The due date for the IHT liability of £80,000 payable by the personal representatives of Jing’s estate is 31 July 2013.
- Jing’s husband will inherit £100,000, her brother will inherit £40,000, and the children will inherit the residue of £80,000 (300,000 – 100,000 – 40,000 – 80,000).