

Estate Planning & Inheritance Tax

The Basics

As with capital gains tax (CGT), the Office of Tax Simplification (OTS) produced two Inheritance Tax (IHT) reports with a series of recommendations on 'simplifying' the tax (released in late 2018 and mid 2019). In March 2021, the government responded to these reports and said it had accepted some of the recommendations. However, none of the accepted recommendations affect rates or thresholds so are of minimal planning interest to those with estates subject to IHT. That said, all bands and allowances related to IHT were frozen in the March Budget until April 2026 and we felt this might be a good time for a brief refresher on some IHT basics and payment issues as it is clear to us from queries we receive that several misunderstandings about these still exist. This is the first of three articles covering IHT.

Bands and Allowances (2021-22)

Where assets pass to a surviving spouse or civil partner, who is domiciled or deemed domiciled in the UK, there is generally no inheritance tax to pay. Gifts to registered charities are also IHT exempt. IHT is charged at 40% on the excess over the bands shown below where the estate passes to any other beneficiary/ies.

The most commonly used allowances are:

Allowance	Amount*
Nil Rate Band	£325,000
Residence Nil Rate Band	£175,000
Exempt Annual Gifts	£3,000

The nil rate band (NRB) can be used against any assets and applies to every individual. The residence nil rate band (RNRB) only applies against property and the property must have been occupied by the deceased at some point. Furthermore, the RNRB only applies when the property passes to a direct descendant (definition found here).

The RNRB is subject to 'tapering' if the total estate exceeds £2m. This means the allowance is reduced by £1 for every £2 by which the estate exceeds the threshold. For example, if the estate was £2.3m, the RNRB is reduced by: £300,000 (excess) / 2 (taper factor) = £150,000. Adding the remaining £25,000 RNRB to the full NRB means £350,000 of this estate would be exempt from IHT.

Any amount of either band that is not used on the first death is potentially transferrable to a surviving spouse or civil partner.

Simple Example

Sam passes away having made no gifts in last 7 years leaving an estate comprised of:

House	£350,000
Personal goods	£35,000
ISA	£310,000
Cash	£36,000
Total	£731,000

Sam's two children are the sole inheritors, IHT due is:
 $(£731,000 - £500,000) \times 40\% = £92,400$

If the exempt annual gifting allowance of £3,000 (or any unused portion) has not been used in the tax year of death or the tax year preceding death, it can be added to any available nil rate bands. In the simple example above, this means the tax-free estate would have increased to £506,000.

Qualifying for the Reduced Rate of 36%

The rate of IHT payable reduces to 36% if 10% or more of your net estate is left to a registered charity. The definition of net estate is important to understand as it is not simply 10% of the estate value as is commonly assumed.

The make-up of an estate can add complexity and you may need to consult a suitably qualified solicitor in these scenarios. However, another example may help establish the basic position for simple estates.

Example

A person dies leaving a house and cash in the bank valued at £1m. They have their own nil rate band and residence nil rate band to use, i.e. £500,000 and they also inherited the residence nil rate band from a spouse who died previously, i.e. another £175,000. They made annual gifts each year up to the maximum allowed and leave £50,000 in their will to charity.

Many people think, "10% of £1m equals £100,000 so the 36% rate does not apply here as the bequest is only £50,000". However, the net estate is calculated as follows:

£1,000,000 (estate) - £500,000 (own NRB's) - £175,000 (inherited RNRB) + £50,000 (charitable bequest) = £375,000

10% of £375,000 is £37,500. So, in this example, more than 10% of the net estate has been left to charity meaning the rate of IHT applying to the estate is 36%.

Payment of any IHT Due – Beware!

If an IHT liability exists, it should be paid by the end of the 6th month following the month of death. If this deadline is missed, interest begins to accrue on the amount owed. HMRC estimate that it takes 6-9 months on average to go through the process. Before assets can be distributed to inheritors, a Grant of Probate must be issued by HMRC. Financial institutions will generally not allow assets to be used/accessed until they receive a UK court sealed copy of the Grant.

Those administering the estate often believe that they will be able to use any liquid asset held in the estate to settle the liability, but unfortunately, this is not the case.

This inability to use all estate assets often catches the person/persons administering the estate off guard – any IHT liability due has to be paid before a Grant of Probate is issued. However, some assets can be used to settle any liability, and these include:

- Bank, building society or National Savings & Investments accounts held in the deceased's sole name
- British Government Stocks, i.e. gilts

Where the estate holds assets which are not easy or quick to sell (property being the prime example), HMRC allow payment of tax due (on these assets only) by instalments over 10 years. Interest would be added each year and if the asset is sold before the end of the 10 year period, any outstanding liability must be settled then. Paperwork submitted to HMRC (form IHT400) must state that there is an intention to pay by instalments.

Returning to our earlier example, how might the £92,400 IHT due on Sam's estate be settled?

- £36,000 cash at bank via the direct payment scheme (bank sends direct to HMRC)
- £0 from personal assets, Sam's children want to retain them
- £0 from ISAs, as there is no grant of probate, these assets cannot be used
- £44,241 attributed to property via 10 instalments of £4,424 (plus interest)
- Leaving £12,159 still to be sourced to settle the full liability for HMRC to be able to issue the grant of probate.

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For estates with a greater proportion of assets where instalments cannot be used, the amount that needs to be found from non-estate assets increases and this can cause executors/administrators some issues. Often the funds required can be borrowed from a lender (a 'probate advance' or 'executors loan') but these borrowings usually require security (which cannot be estate assets) and can have quite high arrangement fees and interest rates, further reducing the inheritance received. Part of any estate plan should therefore consider how any IHT liability will be settled.

Most estates are made up of simple assets and do not include things like private businesses, forests/timber, farmland (each of these have their own exemptions and specialist advice should be taken if this applies to you). Our next piece will cover gifting.

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If you have any questions or comments on this article, please contact:
Niall Allardice | Private Client Director
n.allardice@fundsmith.co.uk

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