

A guide to inheritance tax computations

Synopsis: Calculating the amount of inheritance tax payable.

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Rates

The amount of inheritance tax (IHT) (if any) payable on a transfer depends on the total of cumulative transfers (other than exempt transfers) in the previous seven years. This applies to transfers made on death as well as to lifetime transfers which are immediately chargeable (for example, transfers to close companies or trusts subject to the discretionary (relevant property) IHT regime) or which become chargeable because the donor dies within seven years of making them.

Tax is payable only if a chargeable transfer on a cumulative basis exceeds the nil rate band. The nil rate band is currently £325,000. The nil rate band was first set at this level in 2009/10 after which it continued to be set at this level by Finance Act 2010 for tax years 2010/11 to 2014/15 inclusive. It was then frozen at this same level for tax years up to and including 2017/18 by Finance Act 2014 after which date it was due to rise in accordance with the increase in the consumer prices index (CPI).

However, at the Summer Budget 2015, the Government announced that the freeze would be extended for tax years 2018/19 to 2020/21 and at the March 2021 Budget, the freeze was extended until the end of 2025/26. In November 2022, the freeze was further extended to 2027/28.

On amounts above the nil rate band threshold, tax is charged at a single rate of 40% (with an effective reduction to 36% in some cases – please see below).

Example (2023/24 rates)

Death estate	Tax if no other gifts in previous seven years	Tax if chargeable gifts totalling £150,000 in previous seven years
£	£	£
125,000	Nil	Nil
250,000	Nil	30,000
500,000	70,000	130,000
1,000,000	270,000	330,000

Unless Parliament determines otherwise, as is currently the case, the nil rate band would normally be increased with effect from 6 April each year in line with the increase in the CPI for the year to the previous September, and then rounded up to the next £1,000 – Section 8 IHTA 1984.

However, as mentioned above, the nil rate band has remained at the present level of £325,000 since 2009/10 and will remain at this level until the end of 2027/28.

In addition, legislation included in Finance (No.2) Act 2015 introduced a residence nil rate band (RNRB) for deaths occurring on or after 6 April 2017 where all or part of a qualifying residence is left to lineal descendants of the deceased (or their spouses/civil partners).

The RNRB was initially set at £100,000 (for tax year 2017/18) and had been phased in gradually in annual increments of £25,000 until it reached £175,000 in the 2020/21 tax year.

At the March 2021 Budget, the RNRB was frozen at this level until the end of 2025/26. In November 2022 this freeze was extended to 2027/28.

Additional provisions, included in Finance Act 2016, apply to compensate for the loss of the RNRB in situations where a 'qualifying residence' is sold or replaced with a less valuable residence prior to death.

In such cases an 'additional' nil rate band will be available provided that the sale or downsizing occurs after 8 April 2015 and that assets of a value equivalent to the lost RNRB (plus any lower value replacement property) are left to persons fulfilling the extended definition of direct descendants.

Taper relief

Lifetime transfers which are immediately chargeable to IHT, are charged at half the rate of tax applicable for transfers made on death (i.e. at 20%).

Where such a transfer is made within seven years of death, tax will become due at the full rate and additional IHT may therefore become payable but tapering relief is available for transfers made more than three years before death to reduce the tax liability.

The relief is as follows...

Years since gift	Tax reduction
Less than 3 years	Nil
3-4	20%
4-5	40%
5-6	60%
6-7	80%

Note: where the impact of taper relief means that too much tax was paid on a chargeable transfer when made, that overpaid tax cannot be reclaimed.

Example 1

James gifts £575,000 into a discretionary trust in July 2023. James has made no previous lifetime transfers. The tax payable at the time the gift is made, assuming no annual exemptions are available and that the trustees pay the tax is...

- $(£575,000 \text{ less } £325,000) \times 20\% = £50,000$

If James survives for seven years from the date of the gift no further tax is payable. If, however, James dies, further tax is payable (assuming no increase in the nil rate band) as follows...

A Years survived until death	B Tax payable at death rate	C Tax paid at outset	D Balance payable
	£	£	£
0 – 3	100,000	50,000	50,000
3 – 4	80,000	50,000	30,000
4 – 5	60,000	50,000	10,000
5 – 6	40,000	50,000	Nil
6 – 7	20,000	50,000	Nil

Taper relief also applies to reduce the tax payable on potentially exempt transfers (PETs) that become chargeable because of the donor's death within seven years of the transfer.

Example 2

If, in Example 1 above, instead of creating a discretionary trust, James makes a gift of £575,000 to his brother there will be no immediate tax charge. If James survives for seven years, there will be no tax. If James dies within seven years, assuming a nil rate band of £325,000, the tax payable would be as per column B above. The tax on the PET would be payable by the donee.

Taper relief operates by reducing the tax payable. It is not applied to the amount of the transfer, the full value of which will be included in the donor's cumulation when calculating the IHT due on the donor's death.

Whilst, in Example 2, the PET remains in James's cumulation the nil rate band is fully taken up.

If the value of a PET had been below the nil rate band, the PET would still have formed part of the donor's cumulation - thereby taking up a part of the nil rate

band on death – in the event of his death within seven years, however no taper relief would have been available as no tax liability would arise on the gift itself.

Computation of tax

The amount on which tax is charged is measured by the loss to the donor as a result of the gift. The loss excludes any incidental expenses and capital gains tax incurred as a result of the gift. Where IHT on a lifetime gift is borne by the donor the loss includes the tax. The loss is found by 'grossing up' the net gift to the donee. If the tax is borne by the donee the amount chargeable is calculated without grossing up.

On death, the amount charged is the value of the deceased's estate (as defined in s5 IHTA 1984) immediately before death.

Tax is chargeable cumulatively on each chargeable transfer by reference to the total chargeable transfers made within seven years of that chargeable transfer – Section 7(1) IHTA 1984. This rule applies to transfers which are immediately chargeable, to PETs which become chargeable and to transfers on death. So, a record of gifts made by a donor in the previous seven years is needed in order to determine the tax payable on any one occasion.

As mentioned above, where lifetime transfers are immediately chargeable (that is they are not PETs) the rate of tax due at the point at which the transfer is made is 20%, i.e. half the rate applied to transfers on death.

The rules for computing the tax can be best explained by way of examples. All the examples below, for simplicity, ignore the annual exemption.

Example 3

Lauren, who has used up her annual exemption for 2023/24 and has made a previous chargeable transfer of £175,000 in December 2016, makes a further transfer of £200,000 into a discretionary trust on 1 December 2023 but leaves the trustees to pay the tax. The tax due is calculated as follows...

	£
Tax on 2016 gift of £175,000	Nil
Tax due on first £150,000 of 1 December 2023 transfer	Nil (balance of £325,000 nil rate band)
Tax on £50,000 at 20%	<u>10,000</u>
Tax payable	10,000

Example 4

The facts are as in Example 3, but the donor pays the tax.

Taxed at one half of the death rates, the £200,000 is grossed up to £212,500 (£200,000 plus the £10,000 tax paid plus the additional IHT liability on paying the tax amount).

Tax payable on £62,500 at one half of the death rate (i.e. 20%) is £12,500.

Transfers within seven years of death

If a person dies within seven years of making a transfer, that transfer becomes taxable at the death rate then in force. This applies to all transfers, including those that were PETs when made – Section 7(4) IHTA 1984. Even if tax (at the lifetime rate) has already been paid on the transfer, additional tax may be due. The additional tax is the difference between the tax due at the death rate (but still applied to the value when the gift was made), and the tax already paid which will have been at half the death rate.

If the rate scale has been amended between the date of the transfer and the date of death, the tax due at the death rate is calculated with the benefit of the rate scale in force at the time of the death, but not so as to reduce the tax already paid. No repayments are made Section 7(5) IHTA 1984.

If a PET becomes chargeable because the donor dies within seven years, it too is charged at the death rate, and takes its chronological position for cumulation purposes at the time of the PET. So, it is taxed as the top slice of chargeable transfers made within the seven years before it itself was made, but again with the benefit of the rate scale in force at the time of death applied to the value when the gift was made.

Example 5

Andy made a chargeable lifetime transfer (CLT) of £150,000 on 1 January 2020. On 1 December 2020 he made a PET to Claire of £250,000. Andy dies on 1 November 2023. There is no tax due when the PET is made, but tax is due on Andy's death. This is calculated as follows...

	£
CLT	Nil
Tax on first £175,000 of PET	Nil (balance of nil rate band)
Tax on £75,000 balance of PET at 40% (no tapering relief - within three years)	30,000
Total tax due on the PET	30,000

Once a PET becomes chargeable, it then forms part of the chargeable transfers in the previous seven years, which have to be taken into account in calculating the tax due on later transfers.

This may require re-allocation of the nil rate band, and so increase the tax due on later transfers.

Example 6

The facts are as in Example 5, but on 1 July 2021 Andy made a transfer into a discretionary trust of £200,000.

At the time of this transfer, the tax, payable by the trustees, is calculated as follows...

	£
Tax on £150,000 earlier CLT	Nil
(2020 PET of £250,000 not yet chargeable)	Nil
Tax on first £175,000 of 1 July 2021 transfer (threshold £325,000)	Nil
Tax on £25,000 balance of this transfer, at 20%	<u>5,000</u>
Total tax due	5,000

On Andy's death (threshold £325,000) the tax on this transfer is re-calculated as follows...

	£
Cumulative total of previous transfers	400,000
Transfer into discretionary trust on 1 July 2021	<u>200,000</u>
New cumulative total	<u>600,000</u>
Tax at death rate on £275,000 (£600,000-£325,000)	110,000
<u>Less:</u> tax due on December 2020 transfer	<u>(30,000)</u>
Tax due in respect of 1 July 2021 transfer, at 40%	80,000
<u>Less:</u> tax previously paid at date of transfer	(5,000)
Tax now due in respect of the July 2021 transfer	<u>75,000</u>

Note: no taper relief - donor did not survive this gift by three years.

Example 7

Shane made a PET of £365,000 to his son on 1 May 2018. There are no other transfers before Shane's death on 1 July 2023.

The tax due is calculated as follows...

	£
Tax due on first £325,000	Nil
Tax due on next £40,000 at 40%	16,000
But as the gift was more than five, but less than six years before death, tax due is reduced to £16,000 x 40%	<u>6,400</u>

Example 8

The facts are as in Example 7, except that the gift is into a discretionary trust and immediately chargeable. The tax due at the time of the gift is £40,000 at 20% = £8,000 (threshold in 2018/19 £325,000). The re-calculated tax on Shane's death is £6,400 as shown above, but as this is less than the tax already paid no further tax is due, nor is any repayment of the difference available.

Example 9

Catherine makes gifts which are PETs to their son of £50,000 on 1 February 2021 and £50,000 on 1 February 2022. Catherine dies on 1 December 2023. They leave £100,000 of their net estate of £350,000 to their UK domiciled husband and the residue to their son.

The tax on the residue is calculated as follows...

	£
Tax on PET on 1 February 2021	Nil
Tax on PET on 1 February 2022	Nil
Tax on first £225,000 of estate residue	Nil (balance of £325,000 nil rate band)
Tax on balance of residue £25,000 at 40%	10,000
(Legacy of £100,000 to the wife is an exempt transfer.)	

CLTs made more than seven years before death may continue to have an impact on PETs that become retrospectively chargeable.

Example 10

Josh died on 1 August 2023 leaving a death estate of £550,000. £250,000 was left to their husband, the balance was shared equally between their three children. Josh had made a CLT of £250,000 in July 2015. They also gave £100,000 to their brother in June 2023.

Tax on failed PET made in June 2023	£
Cumulative total of previous transfers	250,000
Failed PET	100,000
Cumulative total	350,000
Tax on failed PET (40% of £25,000)	10,000
No taper relief as death occurred within three years of PET.	
The 2015 CLT was made more than seven years before death, so it is ignored in calculation of tax on death.	
Tax on death estate	
Estate	550,000
<u>Less:</u> exempt transfer to husband	250,000
Chargeable estate	300,000
Cumulative total of previous transfers (failed PET June 2023)	100,000
Tax on first £225,000 of residue	Nil
Tax on balance of £75,000	30,000

Note: the RNRB cannot be offset against lifetime transfers to reduce the tax payable either in lifetime or on death within seven years.

Partly chargeable transfers

There are rules for determining the amount of tax chargeable and for allocating the benefit of exemptions if a transfer is partly exempt and partly chargeable - Ss36-42 IHTA 1984.

The rules operate mainly in connection with transfers on death, but they can also apply, for example, where an interest in settled property comes to an end during a beneficiary's lifetime and the settled fund is then distributed partly to a beneficiary who qualifies for an exemption and partly to one who does not.

The chargeable part of the estate may consist of specific gifts, or residue, or both. A specific gift is a gift of particular assets or of a specified amount. The following paragraphs explain how the tax is worked out in a number of typical cases.

Where the whole of the residue is taxable

If the whole residue of the estate is taxable, the chargeable part of the estate is worked out simply by deducting any specific gifts that are exempt.

Example 11

Rose dies in December 2023 leaving an estate of £375,000. £30,000 is given to a charity and the residue to their son.

The chargeable part of their estate is £345,000 on which tax payable will be £8,000 (i.e. $345,000 - 325,000 \times 40\%$).

Where a share of residue is taxable

If a share of the residue is the only part of the deceased's estate that is taxable, the chargeable part is worked out by first deducting any specific gifts and then apportioning the balance of the estate between the residuary beneficiaries in the ratio that they are entitled to share in the residue. Tax is charged on the amount so apportioned to the non-exempt beneficiaries.

Example 12

Ben died in June 2023 leaving an estate of £700,000. £30,000 is given to charity and the residue equally to Ben's widow and son. The value of the gift to the widow is half of $(£700,000 - £30,000) = £335,000$. So, the exempt part of the estate is $£335,000 + £30,000 = £365,000$ and the taxable part £335,000.

If Ben had made no previous chargeable transfers the tax on the £335,000 chargeable gift to the son is £4,000 and the son's share after deduction of tax will be £331,000.

Where specific gifts do not bear their own tax

The amount of tax payable on a specific gift out of a deceased person's estate depends on whether the gift bears its own tax. If the only taxable parts of a deceased person's estate are specific gifts on which the tax has to be paid out of the residue, the value on which tax is payable is found by grossing up the gifts.

Example 13

Chris, who had made no previous chargeable transfers, died in June 2023 leaving an estate of £925,000. Under the Will their son receives a legacy of £400,000, the tax on which is payable out of the residuary estate. The residue is given to Chris's widow. Of the £400,000 only £75,000 is taxable. This, grossed up at 40%, comes to £125,000.

The total grossed-up legacy is therefore £450,000. This is the amount that is liable to tax, and the tax payable out of the residuary estate is £50,000 leaving a net legacy of £400,000. The widow is entitled to receive £475,000 ($£925,000 - £450,000$) out of the estate of £925,000.

Where specific gifts bear their own tax

Where, under a Will, a specific gift bears its own tax the gift does not need to be grossed up. It should be noted that a claim to legal rights in Scotland is treated for

this purpose as a specific gift that bears its own tax, calculated as a share of the estate before deduction of tax.

Example 14

Mike, having made no previous chargeable transfers, died in August 2023 leaving an estate of £550,000. A legacy of £400,000 is given to their son and the residue to their widow. Mike's Will provides that the tax on the legacy of £400,000 is to be paid out of the legacy.

The tax attributable to £400,000 is £30,000. The son is entitled to receive £370,000 out of the estate and the widow £150,000.

Charitable giving to reduce rate of IHT

A reduced rate of IHT applies for deaths which occur on or after 6 April 2012, where a deceased leaves 10% or more of their net chargeable estate to charity. The net chargeable estate is what remains after deductions of IHT exemptions, relief and the nil rate band. In such cases, the usual 40% rate will be reduced by 10% (i.e. 40% to 36%).

This was introduced to encourage charitable giving and philanthropy and to support the voluntary sector. Reducing the rate of IHT by 10% for those who leave 10% or more of their net estate to charity will reduce the cost of giving to charity through bequests.

The relief is designed so that the benefit of the tax saving is reflected in the bequests received by charities and not in payments to other beneficiaries.

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