

AF1 Inheritance Tax 2022/2023

Part 2: Calculating liability on death

The milestones for this part are to understand:

- The principles of calculating IHT on a deceased's estate
- How to deal with outstanding PET and CLT
- The rules on transferable Nil Rate Bands.
- How IHT is payable.

IHT taxes the transfer of capital from one person to another. On death, the deceased's estate is transferred to beneficiaries either through a will or through intestacy rules.

- Transfers on death will either be exempt or chargeable.
- Exempt transfers are paid directly to the beneficiary with no IHT liability.
- All chargeable transfers, go through a kind of toll gate which is the deceased's Nil Rate Band. Transfers below this are taxed at 0%. Transfers above it are taxed at 40%.

Put another way, the basic formula for calculating IHT is

Chargeable estate less NRB x 40%

Tom has a chargeable estate of £425,000. The IHT payable is:

	£425,000
Less NRB	£325,000
	£100,000 @ 40% = £40,000

Unfortunately any AF1 question will be more complicated!

There are four steps to calculate an IHT liability on death:

1. Calculate the value of the estate
2. Deduct any exempt transfers. (This is the **chargeable estate**)
3. Calculate the NRB
4. Deduct the NRB from the estate (This is the **taxable** estate) and charge at 40%

The responsibility for paying IHT falls primarily on the executors of the deceased's estate. However, there are occasions when the recipient of a legacy must pay tax.

Calculating the value of the estate

A person's estate is broadly all the assets they owned on death less any liabilities such as outstanding loans. This will also include assets that can be claimed by the executors such as the proceeds of a life policy that is not written in trust

Any jointly owned assets are normally split in proportion to the number of owners. A house held on a joint tenancy basis automatically goes to the survivor but they are deemed to receive 50% of its value.

Greg and Tina are not married and own their home on a joint tenancy basis. The property has a value of £500,000. Greg dies and Tina becomes the sole owner. For IHT purposes she has received £250,000

Outstanding loans made by the deceased, including a loan trust, should also be included since the executors can reclaim this money. Business assets should also be included although there can be a relief for these which will be dealt with in a later part.

The following will not be part of the estate:

- Uncrystallised or drawdown pension funds.
- A life policy written in trust since the sum assured will be paid to the trustees and not into the estate.
- Any interests the deceased had in some trusts. Information on this can be found in the Trusts section

Deduct exempt transfers

Having calculated the estate any exempt transfers are deducted. There are only two:

- Transfers to a UK domiciled spouse/civil partner.
- Gifts to charities or political parties

Note that the £3,000 annual exemption cannot be used on death. It is a lifetime exemption only.

Once any exempt transfers have been deducted the remaining estate is chargeable. Transfers up to the NRB are charged at 0% and 40% for transfers above that

Calculating the Nil Rate Band

Whilst the standard NRB is £325,000 the estate's NRB may be higher or lower than this. In some cases, the estate may have no NRB at all.

- It will be reduced by PETs and CLTs made in the seven years before death.
- It can be increased by transferring any unused NRB from a deceased spouse.
- There is also the **Residential Nil Rate Band (RNRB)**. This is will be looked at in the next part

Outstanding PET & CLT

A PET or CLT made in the seven years before the donor's death becomes a failed PET or CLT.

It is often said that "the PET/CLT is added back into the estate". This is incorrect. Failed PETs or CLTs are deducted from the nil rate band at date of death in chronological order with the earliest being deducted first.

Effectively any PET or CLT will reduce the amount of nil rate band available to the estate for seven years after it was made.

Maria made three gifts to her daughters. (The £3,000 annual exemption has already been deducted) Alice received £50,000 in January 2013, Betty received £70,000 in August 2014 and Charlotte received £80,000 in July 2018. Maria died in May 2021

The gift to Alice is exempt as it was made more than seven years before Maria's death. The other two have failed and must be deducted from the NRB.

Betty's gift is the first to be deducted (£325,000 less £70,000 = £255,000)

Charlotte's gift is then deducted from the remaining NRB (£255,000 less £80,000 = £175,000)

The NRB available to the estate is £175,000

A PET/CLT "freezes" the value at the time of the gift. If in the previous example Betty had invested her gift and at the date of Maria's death it was worth £100,000, you would still deduct £70,000 from the NRB.

In the previous calculation, the estate had some NRB. In other cases, a previous PET or CLT will be greater than the available NRB as in this example.

Brian makes a gift of £425,000 to his son Bill. Two years Brian dies leaving an estate of £500,000 which is passed to his unmarried partner.

The PET used up all the NRB so the entire estate of £500,000 will be taxed at 40%. As the PET was £100,000 above the NRB this also becomes chargeable and the recipient, Bill, becomes liable to pay £40,000. (£100,000 x 40%).

All failed PETs are dealt with in chronological order starting with the oldest. This can be illustrated by extending a previous example.

Maria made three gifts to her daughters. Alice received £50,000 in 2013, Betty received £70,000 in August 2014 and Charlotte received £80,000 in July 2018. Maria made a PET of £100,000 to a fourth daughter Donna in August 2019 (In all cases the £3,000 annual exemption has already been deducted). Maria died in May 2021.

The gift to Alice is exempt as it was made more than seven years before Maria's death. The other three have failed and must be taken into account. If the gift to Charlotte's was the final one the estate would have a NRB of £175,000

Donna's gift wipes out the NRB and £25,000 becomes chargeable. Donna is liable and pays £10,000 (£25,000 x 40%)

In an exam, your answer should be set out like this:

NRB	£325,000
PET to Betty	<u>70,000</u>
	255,000
PET to Charlotte	<u>80,000</u>
	175,000
PET to Donna	<u>200,000</u>
	(£25,000)

Donna is liable to tax at 40% on £25,000

The estate does not have a NRB

The rule that PETs are deducted in date order can lead to some odd outcomes.

Jane wins a large lottery prize and gives her son £200,000 on July 1 2017. Two weeks later she gives £200,000 to her daughter.

If Jane dies within seven years both PETS will fail. As the gift to the son was the first to be made this will use up £200,000 of the NRB. The gift to the daughter will use up the remaining £125,000 and £75,000 will be chargeable. The daughter will have to pay £30,000

This could have been avoided if Jane was married. She could gift her husband £200,000 which would be exempt and he would gift this to his son. If either Jane or her husband died within seven years, both PETs would be within the NRB so no tax would be payable by the recipient.

Taper Relief

Taper relief is probably the most misunderstood aspect of IHT. The important thing to remember is that taper relief reduces the tax payable by a person receiving a gift. It does not reduce the size of the PET nor does it reduce the tax paid by the estate.

Brian makes a gift of £425,000 to his son Bill. Four and a half years later Brian dies leaving an estate of £500,000 which is passed to his unmarried partner.

As the NRB has been used up the excess is chargeable on Bill. This is $(£425,000 \text{ less } £325,000) \times 40\% = £40,000$

Taper relief applies therefore only 60% of tax is payable i.e. £24,000

This is payable by Bill

The PET used up all the NRB

Tax on estate is $£500,000 \times 40\% = £200,000$

This is payable by the executors

The taper relief rates will be given in the exam tax tables.

Transferable Nil Rate Bands

It is possible to increase an estate's NRB by transferring any unused nil rate band from a spouse/civil partner who died before them. An unused NRB will typically occur because the first to die left everything to the surviving spouse. This is an exempt transfer so the deceased's NRB was not used.

The rules are as follows:

- The couple must have been married at the time of the first death
- The amount of transferable NRB is expressed as a percentage of the NRB on first death. (First death's NRB/NRB at date of first death)
- This percentage is applied to current NRB and added to the NRB available to the survivor's NRB.
- The first transferable NRB must be claimed by the executors of the second deceased within two years of the second death.

Sally died and left all her estate to her husband Harry. This was an exempt transfer so she did not use any of her NRB which means 100% of her NRB that can be transferred to Harry.

Any legacies made to other people on the first death will have used up some of the NRB.

George died when the NRB was £200,000. He left £20,000 to each of his two children with the rest of his estate to his wife Elizabeth.

The £40,000 legacy is chargeable, so his estate had an NRB of £160,000.

The percentage available is $£160,000/£200,000$ which is 80%.

80% of £325,000 is £260,000 which added to £325,000 gives her estate a NRB of £585,000

Just because everything had been left to the surviving spouse on first death does not mean that 100% NRB can be claimed.

Mia died in August 1996 when the NRB was £200,000. and left everything to her husband Len. His executors are trying to claim her NRB. It seems that 100% can be claimed but further checks show that Mia made a gift to her daughter of £100,000 three years before she died

Her NRB would have been £100,000 so 50% of her NRB was used meaning Len's executors can only claim 50% or £162,500

Someone who has more than one predeceased spouse can claim any unused relief from both. However, the maximum that can be claimed is 100% of the NRB so the maximum claimable would be £650,000.

Helen has been married twice and both her husbands have died. Her first used up 80% of his NRB so 20% is left. Her second used 30% of his NRB so 70% is left. Her executors can claim from both to allow 90% of the NRB to be transferred to her.

However, if her first husband did not use any of his NRB and her second still had 70% left, her executors could only claim 100% and not 170%

Now look at this possibility.

Sam and Lisa are married both having lost their first spouse. Their respective spouse's left everything to them so when Sam and Lisa die, their estates can claim 100% of their NRB.

Sam dies and leaves everything to Lisa. This would be exempt but when Lisa dies her estate can only transfer £325,000 even though both her husbands had not used any of their NRB.

Assuming Lisa didn't need any money from him, Sam could have left up to £650,000 to someone else as this would be within his NRB and his late wife's NRB. On Lisa's death her estate would still have an NRB of £650,000 after transferring the NRB of her first husband.

The same exercise could be carried out if Lisa died first.

Calculating the tax

Having established the value of the estate and the NRB the rest of the calculation should be straightforward. The rate of IHT is 40% for transfers over the NRB. This can be reduced to 36% if a sufficiently large charitable legacy is made This will be looked at in a later part

Pulling all the previous points together here is an example of the structure that should be followed in calculating an IHT liability.

Adam's wife died in 2002/03 when the NRB was £250,000. She had made a gift to her sister in 1997 of £50,000.

She had made no previous gifts.

Her will left everything to Adam apart from a legacy of £5,000 to each of her three grandsons.

Adam gifted £100,000 to his son in August 2014 and £150,000 to his daughter in May 2018. He had made no previous gifts. Adam died on 1 October 2021 with an estate of £600,000

Step 1 Calculate how much NRB his wife had left

NRB at date of death		£250,000
PET to sister	£50,000	
Less 2 annual exemptions	<u>6,000</u>	
	£44,000	<u>44,000</u>
NRB available		206,000
Less chargeable gift (3x £5K)		<u>15,000</u>
Unused NRB		191,000

Step 2 Calculate percentage unused and apply to current year's NRB

$$\begin{aligned} &£191,000/£250,000 \times 100 = 76.4\% \\ &£325,000 \times 76.4\% = \qquad \qquad \qquad £248,300 \end{aligned}$$

Step 3. Calculate Adam's NRB and add to his wife's

		£325,000
Less PET to son	£100,000	
Less 2 annual exemptions	<u>6,000</u>	
	£94,000	<u>£94,000</u>
		£231,000
Less PET to daughter	£150,000	
Less 2 annual exemptions	<u>6,000</u>	
	£144,000	<u>£144,000</u>
		£87,000

Total NRB £248,300 + £87,000 = £335,300

Step 4 Deduct NRB from estate and calculate the tax

Estate	£600,000
Less NRB	<u>335,300</u>
	264,700
£264,700 @ 40% =	£105,880

Calculating the liability with Chargeable Lifetime Transfers

In principle, there is no difference between the treatment of outstanding CLTs and PETs. If any CLTs were made in the seven years before death they are deducted from the nil rate band in chronological order. If this does not exhaust the NRB no further action is required

If the CLT has used up the NRB at date of death, the trustees will be liable to pay the tax but can offset any lifetime tax paid.

Francesca made a gift of £500K into a Discretionary Trust in July 2018 when the NRB was £325K. The trustees would have paid £35,000 in IHT.

She died in June 2021 when the trust property was valued at £600K

The original value of the gift is £175,000 in excess of the NRB which is taxed at 40% giving a tax liability of £70,000. No taper relief applies but the trustees can deduct the £35,000 paid at the time of the gift giving a final bill of £35,000

If three years have elapsed since the gift was made taper relief can also be used

Nicholas paid £500,000 into a Discretionary Trust in June 2016 when the NRB was £325,000. The initial tax paid by the trustees would have been £35,000

He died in May 2021. The death tax is

Value of CLT	£500,000
Less NRB at death	<u>£325,000</u>
Chargeable amount	£175,000
£175,000 @ 40%	£70,000
Less taper relief (40%)	<u>£28,000</u>
	£42,000
Less tax paid	<u>£35,000</u>
	7,000

Taper relief is always taken off before credit is given for the tax paid at the time of the gift. If the tax after taper is higher than the tax paid at the time of the gift there is no further liability but there is no refund. In the above example if taper relief at 60% had been available £28,000 would be payable but the tax paid at the time would wipe this out This excess payment of £7,000 could not be reclaimed.

In practice, the interaction of PET and CLT is more complicated and this is covered under the part entitled "The 14 year rule."

Take care if the case study states that the donor elected to pay tax on the initial gift.

Zara made a CLT of £400,000 and elected to pay the tax

The gift should be grossed up ($£400,000/0.8$) to £500,000 and this should be entered as the amount of the CLT in calculating the liability on death.

Paying IHT

The executors are responsible for preparing an IHT return and paying any IHT on the deceased's estate.

If death occurred after January 1 2022, the executor does not need to report the value of an **excepted estate** to HMRC.

An excepted estate is one where there is no IHT due therefore the executors do not need to give a full IHT account on IHT400.

The executors must confirm on the probate application that the estate meets the excepted estate criteria and whether an unused NRB/RNRB is being claimed,

There are three types of excepted estates:

- Low value estates (gross estate below available NRB)
- Exempt estate. This is one where the gross estate is less than £3m and the estate has passed to a spouse/civil partner and/or a charity
- Foreign domiciliaries. This is an estate of a non UK domicile where the UK assets are less than £150,000

In all cases the probate form must include:

The **estate's gross value**. The value of the deceased's assets and any gifts they made in the seven years before death

The **estate's net value**. The gross value less any debts

The **estate's net qualifying value** that is the net value minus any assets left to spouses/civil partners and charities plus and exempt assets, e.g, AIM shares

If it is not an excepted estate and IHT is due the executor must submit a list all the deceased's assets and lifetime gifts to HMRC within 12 months of death using **form IHT400**. HMRC will then calculate the tax due

If the form is not submitted within the time period penalties will be incurred:

- £100 for late delivery and a further £100 if delivered between 6 and 12 months late.
- A fine up to £3,000 can be made if still not delivered after 12 months.

The executor must be pay the tax six months after the end of the month in which the deceased died. If death occurred in January the IHT must be paid by July 31. If death occurred in February IHT must be paid by August 31 and so on. Interest will be charged if the deadline isn't met.

A recipient of a gift must pay any tax six months after the end of the month in which the deceased died. If the recipient fails to pay the executors will be liable

If IHT400 hasn't been completed by the payment deadline the executors can estimate the tax and make a payment on account,

Probate cannot be given (and therefore assets cannot be sold to pay IHT) until the tax due has been paid. The executors could:

- Pay from their own resources and claim this back from the estate. If they don't have the resources to do this they can take out an executor's loan.
- However the deceased's current account can be used to pay the tax directly to HMRC using the Direct Payments Scheme.

Where the main asset is a house, it may be necessary to sell this to raise the money to pay the tax. In that case the executors can pay 10% of the tax on the due date. They then have 12 months to sell the house and pay the full balance.

If the plan is to continue to live in the house then the IHT can be spread over 10 yearly payments. Interest will be charged after the 6 month dues date.

HMRC will also consider accepting works of art in lieu of payment.

Karl's estate has an IHT liability of £400,000. His estate included two pieces of sculpture by Henry Moore worth £300,000. HMRC could accept these as part payment of the tax. If they did, the sculptures would then be placed in a national museum or gallery.

That concludes this part so you should now understand:

- The principles of calculating IHT on a deceased's estate
- How to deal with outstanding PET and CLT
- The rules on transferable Nil Rate Bands.
- How IHT is payable

Sources and further reading

<https://www.gov.uk/inheritance-tax>

<https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/transferable-nil-rate-band-facts/>

<https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/inheritance-tax-taper-relief/>

<https://www.gov.uk/paying-inheritance-tax>