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When do you pay inheritance tax? What the threshold is, 7-year rule explained and if you can avoid paying

HMRC took a record £6.1bn in inheritance tax last year, but there are ways to limit your bill

Inheritance tax is no longer a tax bill that only affects the very wealthy.

Soaring house prices and rising stock markets, coupled with the fact that the inheritance tax threshold has not risen since 2009, means that an increasing number of families are being dragged over the limit and the bills are getting bigger.

Some £6.1bn was paid in inheritance tax in the 2021-22 tax year, up by about £730m on the year before, according to HMRC.

Here's how it works, and how you might be able to curb your tax bill.

What is the inheritance tax threshold?

The inheritance tax threshold is £325,000. If your estate (a catch-all phrase for your possessions, property and savings) adds up to more than this amount, anything above this will be taxed.

The rate is 40 per cent. This means that if your estate is worth £600,000, you would pay an inheritance tax bill of £110,000 – the first £325,000 is tax-free, so £275,000 of your estate would be taxed at 40 per cent.

There is a slight complication called the "nil rate band". This gives you an extra £175,000 tax-free if your main residence is passed to your children or grandchildren. This effectively gives you a tax-free allowance of £500,000, if you choose to pass on your home this way.

In the above example, your tax bill would drop to £40,000 (40 per cent of the £100,000 above the threshold).

When is your estate free from inheritance tax?

As you would expect, any estate worth less than the £325,000 threshold (or the £500,000 threshold if you are passing your home to a child or grandchild) is free from inheritance tax.

Your estate will also be completely free from inheritance tax if everything is passed to a spouse, civil partner, charity or community sports club.

How do you pay inheritance tax?

Obviously, you won't personally pay your own inheritance tax bill. Your executors (the people you have put in charge of sorting out your affairs when you die) will do this as part of the probate process.

The bill can be paid in one go, or in 10 annual instalments. If your estate has enough easily accessible cash to pay the bill, it is likely to be paid straight away.

However, often an estate will have property or shares that will need to be sold in order to pay HMRC. In this case, the executors will opt to pay the bill in the yearly instalments.

It is only after the inheritance tax bill has been settled that your executors can begin to pass on your assets to your beneficiaries (those who will inherit parts of your estate).

Can you reduce your inheritance tax bill?

Yes, there are legal ways to reduce the amount of inheritance tax your family will pay, but it takes some planning.

The most common of these is known as the "seven-year rule" – crudely, any gift is tax-free if you live for at least seven years after giving it.

These gifts are classed as a "potentially exempt transfer". In order for it to become tax-free after seven years, you need to give up any access to it.

If you die within seven years, the gift then forms part of your estate. Tax will be due, but on a sliding scale depending on how long you live. For example, if you live for four years after the gift is given, the tax is 32 per cent. If you live for seven, the tax is 8 per cent.

The seven-year rule means that it is worth thinking about giving money or assets you no longer need while you are healthy – but only if you are sure that you will not need it.

Are any gifts exempt from inheritance tax?

Outside of the seven-year rule, there are other tax-efficient ways to give away parts of your estate.

Every year, you get "gift allowances". This is a certain amount you can give away that does not form part of your estate (even if you died the very next day).

In general, the limit is £3,000 in each tax year. This can be to one person, or spread across the whole family. You can also give £250 per person to as many people as you like.

Weddings and civil partnerships come with their own rules: £5,000 to a child, £2,500 to a grandchild or great-grandchild, and £1,000 to everyone else.

You can also "gift from income". You can give someone regular gifts from surplus income, providing it does not hinder your own standard of living, and the money will be tax-free (it won't form part of your estate).

This money has to be "surplus", so has to be left over after all of your regular expenditure has been met, and needs to be from your income, so it cannot be made by selling assets. It also needs to be regular, so could be a monthly or yearly payment.

For example, a couple with a combined pension income of £65,000 who spend £50,000 a year could give their two children £7,500 each (making use of their spare £15,000) without incurring tax implications.

If you plan to do this, make sure you keep a record that shows that the gifts are regularly made from your income, as HMRC may decide to check.

Can trusts help reduce inheritance tax?

Trusts can help you manage the passing down of assets and minimise your inheritance tax bill.

They are legal agreements and can affect your wider finances, so it's worth talking to both a financial adviser and solicitor before you make any decisions.

One option is a discounted gift trust, where you can gift the money but still access it until you die or the fund runs out. Another is a discretionary trust, where the money is moved outside of your estate but you still have some control over it (although you won’t be able to use it for personal use).

By Imogen Tew
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