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What is inheritance tax?

Inheritance tax (IHT) is the merging of life's two certainties, so it's important to understand how it could affect you – especially if you're planning for what happens once you or one of your loved ones have died.

So what is inheritance tax? It's a tax paid on what someone inherits, or on the estate of someone who's died. That could be anything such as property, money, a business or possessions.

Did you know that inheritance tax is forecast to bring in more than £7 billion for government coffers for the 2023/2024 tax year?[1]

Why does it exist?

The idea of inheritance tax is to redistribute wealth. But inheritance tax can be a controversial topic, because tax is paid on income during someone's lifetime anyway. Purchasing property incurs tax, and even the initial cost of purchasing everyday stuff can include VAT. So, some people argue that inheritance tax is unfair, considering it is a tax on something that's already been taxed.

In reality, though, only about 4% of estates actually incur inheritance tax. Most people don't have to pay a thing.[2]

What's not taxed?

If you leave anything to your spouse or registered civil partner, it's not subject to inheritance tax on the first death. Even if the value has an especially large amount of zeros. But, to benefit from this rule, you must be married or in a registered civil partnership. If you're simply living together – even if you've been living together for 50 years – any money you leave them will count towards your individual inheritance tax-free allowance.

Your individual inheritance tax-free allowance

Like many other kinds of tax, everyone has an 'allowance'. For inheritance tax, it's £325,000. Where the value of your estate falls below that amount, it is not subject to inheritance tax.

And, if you leave anything to a charity or a community amateur sports club it's not subject to inheritance tax – even if it's over the tax-free threshold.

What's more, if you decide to leave your house to your children or grandchildren (including fostered, adopted or stepchildren), your tax-free threshold could increase to £500,000. That's because of something called the 'residence nil-rate band', sometimes dubbed the 'main residence 'nil-rate band. It's actually an additional tax-free allowance of £175,000, which, when added to your initial £325,000 nil- rate band, equals £500,000.

However, the extra allowance only applies if your estate is worth less than £2 million. If your estate is above that, the main residence allowance will decrease by £1 for every £2 above £2million that the estate is worth.

[1] Inheritance tax - Office for Budget Responsibility
[2] Inheritance Tax statistics: commentary - GOV.UK

PENSION geeks

If your home is left to a 'discretionary will trust', it won't qualify for the additional allowance.

Moreover, if your home is worth less than £175,000, you can't use the unused portion of the residence nil-rate band to offset against other assets in your estate.

How much tax will I pay?

If it looks like you'll be paying inheritance tax, there are a few things to know.

One of the most obvious points is that the standard inheritance tax rate is 40%.

That means, for instance, if you're leaving behind an estate valued at £500,000, you'll be taxed £70,000.

That's because £70,000 is 40% of £175,000, which is the difference between £500,000 and your allowance of £325,000.

What counts as your estate?

A fair amount counts as assets of your estate, but not everything you'd think of makes the cut. The following list shows some of the types of assets that can count:

- Your home (minus the deductions of a mortgage).
- Other properties (minus the deductions of a mortgage).
- Cash
- Investments
- Possessions
- Life insurance (if not in trust).

The total value of these assets, minus the tax-free allowance and the potential residence nil-rate band, is the amount of money that would be 'exposed 'to inheritance tax.[3]

There's actually a handy inheritance tax calculator, courtesy of HMRC, which can give an estimation of what could be owed.

What about a pension?

The headline is that pensions typically do not count towards the value of your estate for inheritance tax purposes.

But – and this is an important but – pensions remain tax-efficient only as long as they remain in a pension. That's because once you've withdrawn your pension and turned your hard-earned savings into an income, that cash could then be considered an asset of your estate.

You can, however, normally pass your pension on to your loved ones without having to navigate inheritance tax – as long as you've not yet taken your pension as an income.

[3] A guide to Inheritance Tax | MoneyHelper

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When it comes to passing on your pension, it's important to 'nominate a beneficiary'. This means choosing someone to receive your pension after you die.

Your pension provider might have asked you to complete a form – either online or via post – to nominate a beneficiary. If you're unsure whether you've completed it, or even if you're stumped at where to start, then your pension provider has probably got the answers.

Remember that if you have more than one pension, you'll need to complete a separate form for each different account you hold.

Or, if you seem to have misplaced a pension, you can usually find the details of it in some old paperwork. Most people have a stash of old letters hiding somewhere in the house! But, if you can't find enough detail on paper, then the Pension Tracing Service could help you find it again.

Can I reduce how much tax I'll pay?

Yes. One technique starts with spending. It's simple enough: spending your money decreases the overall value of your estate, therefore decreasing the overall inheritance tax you'll pay on it should it become an inheritance. What better opportunity to spend on the holiday you've been dreaming about, or on tickets to a show or a sports game. Maybe there's a new restaurant opened down the road that's been getting rave reviews?

Just remember that buying something like a car, furniture or art will all count as a possession, and could be included in your estate.

Another way to reduce your inheritance tax could be to contribute to a pension, instead of a savings account. That's because, until money is taken from your pension for retirement, it remains shielded from inheritance tax.

And you could even contribute to a Junior Pension – a scheme that lets you contribute £2880 per year whilst also benefitting from a 20% government tax relief, just like a regular defined contribution pension. This money can then be left to grow free from UK income tax and capital gains tax, until the child reaches retirement age, when they can withdraw it.

In fact, gifting money is another way to reduce your inheritance tax. If someone you love is saving towards a house deposit, or pays off a student loan with every pay packet, gifting them money towards that goal could reduce your inheritance tax liability. However, if you don't live more than 7 years after you've made the gift, they might have to pay inheritance tax. There are a few ways you can gift money to reduce how much tax you might have to pay:

- Married couples and registered civil partners can transfer each other money without any liability – during their lifetime or on death.
- Each tax year you can transfer up to £3000 to anyone you like using your annual allowance. You can also use up any unused allowance from the previous year, too.
- You can gift anyone up to £250 each tax year, as long as you haven't given them anything in the same tax year.
- If you find yourself with extra income each year that you don't need, you can gift it to someone. You'll need to keep track of this, using HMRC form IHT403.

PENSION geeks

- You can even gift towards marriage or weddings. For your children, you can gift up to £5000 per child from each parent. If it's your grandchildren, that changes to £2500. For anyone else, it's £1000.

- You can also gift money to charities or political parties, should you want to. Whatever you gift is not subject to inheritance tax, and if you leave 10% of your net estate to a charity in your will, your inheritance tax rate will lower to 36%.

- You can even use your money to make an investment for your child to help lower your inheritance tax. Junior ISAs allow you to contribute £9000 per year (in the 2024/2025 tax year). These accounts are designed for children under 18, and they may only access it once they become an adult.

Gov.uk provides more information on what exactly constitutes a gift.

If you are considering gifting or investing your money as an effective way to lower your inheritance tax, it might be worth speaking to a financial adviser, who could provide ideas based on your specific circumstances and intentions. MoneyHelper could also help - the service provides free, impartial guidance with money, and it's backed by the government.

Remember, if you do need to pay inheritance tax, it must be paid by the end of the sixth month after the person died. If it's not paid by then, HMRC will begin to charge interest.

What's more, make sure to keep a record of how you've valued the estate. HMRC could ask to verify your record up to 20 years after IHT is paid.