CHAPTER 1

INTRODUCTION TO INHERITANCE TAX

1.1 General Introduction

Inheritance tax was introduced in the 1986 Finance Act to take effect from March 1986. Inheritance tax was a replacement for Capital Transfer Tax which itself replaced Estate Duty. The statutory rules governing inheritance tax are contained in the Inheritance Tax Act of 1984.

IHT accounts for around 1½% of total Government revenue, bringing in about £3.5 billion. This is in part due to a generous array of inheritance tax reliefs and also because, with sensible tax planning, IHT can be an easy tax to avoid. In recent years there has been much press speculation about a possible overhaul of the inheritance tax system. However, the rules as they exist today have not changed significantly since the mid-1980s.

1.2 Section 1 IHTA 1984

IHTA 1984, s. 1

S.1 IHTA 1984 tells us that "inheritance tax is charged on the **value transferred by a chargeable transfer**". The value transferred for IHT purposes is measured by the **"loss to donor"** principle. If an individual gives away an asset, the **value of his estate will be reduced.** The amount of that reduction is the "loss to donor".

A **"chargeable transfer"** for inheritance tax purposes will either be a **lifetime gift** or a **transfer on death**. Most of us think of inheritance tax as a death tax. Indeed when an individual dies he is treated as making a chargeable transfer equal to the value of his assets at the date of death. However, if an individual makes a lifetime gift, the value transferred by that gift may **also** be chargeable to inheritance tax. We shall look at the different types of chargeable transfer in a later chapter.

1.3 Domicile

Individuals who are **domiciled in the UK** are liable to inheritance tax on transfers of **all worldwide assets**, wherever they are situated. However, individuals who are **domiciled outside the UK**, are liable to inheritance tax on transfers of their **UK assets only.**

If a non-domiciled person owns assets which are situated outside the UK, those assets are called **"excluded property".** Transfers of excluded property are ignored for inheritance tax purposes. The concept of domicile is very important for inheritance tax, and the residence status of an individual is largely insignificant.

IHTA 1984, s.6

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1.4 Transfers ignored for IHT

The IHT legislation contains a list of transfers (or "dispositions") which are ignored for inheritance tax purposes.

As a general principle, if an individual makes a **gift without any "gratuitous intent",** that gift is disregarded for IHT purposes. Therefore if an individual enters into a genuine transaction with an unconnected person, but as a result of that transaction the value of his overall estate falls, he is not treated as having made a transfer of value for IHT purposes. Therefore a donor must deliberately intend to make a gift in order to make a transfer of value for inheritance tax purposes. Genuine "arms length" sales are ignored.

IHTA 1984, s.10

Expenditure on the **maintenance of an individual's family** is not treated as a transfer of value for inheritance tax, even though the donor's estate will be reduced as a result of the gift. For example, if a father pays school fees on behalf of his children, or if an individual makes provision to look after a dependent relative, such dispositions will be ignored for inheritance tax.

IHTA 1984 s.11

If an individual **gives up his right to receive remuneration** from an employer, or repays any amount of remuneration, he is **not** treated as making a transfer of value for inheritance tax purposes. Similarly if a shareholder **waives his right to a dividend** within 12 months before that right accrues to him, this is also disregarded for IHT.

IHTA 1984 s.14

IHTA 1984, s.15

1.5 The "loss to donor" principle

IHTA 1984, s. 3

When measuring the value transferred for IHT purposes, we must look at the **loss to the donor's estate** as a result of the transfer. It is very important to realise that what the donor loses as a result of a gift, is not always the same as what the donee receives. To measure the loss to donor, we start by taking the value of the donor's estate – i.e. the value of his total assets – **before** he makes the gift. We then **deduct** the value of the donor's estate **after** the gift, and the difference between the two numbers is the "loss to donor".

	£
Value of estate before gift	X
Less: Value of estate after gift	(X)
Loss to Donor	X

This is the "value transferred" which will (in certain circumstances) be chargeable to inheritance tax. This principle is commonly applied if a donor gives away shares in private or **unlisted companies**.

Illustration 1

Jim owns 6,000 shares (a 60% holding) in a company called Royle Limited. Jim decides to give 2,000 of his shares to his daughter Denise. At the date of the

gift, a 60% holding of shares is worth £50,000, a 40% holding is worth £20,000, and a 20% holding is worth £8,000.

It is important to realise when dealing with shares in private companies, that **not all shares are worth the same amount**. For instance, a 60% holding will be worth considerably more than a 40% holding, because if an individual has more than 50% of the shares he has power to **control** the decisions of the company.

We need to work out the value transferred by Jim to Denise. To do this we use the loss to donor principle.

	£
Jim's shares before transfer	
= 60% holding worth	50,000
Jim's shares after transfer	
= 40% holding worth	(20,000)
Loss to Donor	£30,000

The value transferred by Jim to Denise is £30,000.

You will see that what Jim has lost as a result of the transfer (£30,000), is not the same as what Denise has gained. Denise has gained a 20% holding which is worth £8,000. For inheritance tax purposes we must consider the loss to donor rather than the gain to donee.

1.6 Related property

IHTA 1984, s. 161

When measuring the loss to donor, we must also take account of **"related property"**. In simple terms, a person's assets are related to similar assets **owned by his or her spouse or civil partner**. Therefore when measuring an individual's transfer of value for IHT purposes, we must take account of similar assets held by one's spouse or civil partner.

Note it is **only** assets held by one's spouse/civil partner that are related property for IHT purposes. Similar assets owned by one's children, brothers and sisters, boyfriends and girlfriends etc., are **not** related property.

The "related property" rules were introduced to prevent a husband and wife avoiding IHT by transferring assets between them. The "related property" rules effectively **treat assets held jointly** by a husband and wife **as one asset** for inheritance tax purposes. Therefore when a husband and wife own joint assets – for example shares in the same company – if either of the spouses gives some shares away, the related property rules will affect the value transferred.

Illustration 2

Returning to the example of Royle Limited, which had issued share capital of 10,000 shares. Assume now that Jim owned 6,000 shares. His wife Barbara owned 3,000 shares. Their son Anthony owned the remaining 1,000 shares. The respective share values are given below:

Shareholding	*Value per share*
0 – 25%	£4 per share
26 – 50%	£5 per share
51 – 74%	£8 per share
75 – 100%	£12 per share

As is the case for all shares in private companies, the **value per share** will **increase depending on the number of shares owned** by the shareholder.

For example, because Jim has control of the company (he has more than 50% of the shares), each of his shares are worth £8 at the date of the transfer. However, because Anthony has a minority holding – he only has 10% of the company's shares – his shares are only worth £4 each.

Jim wishes to give 2,000 of his shares to his daughter Denise.

Our requirement is to calculate the value transferred by Jim for inheritance tax purposes. To do this we will use the loss to donor rules, but this time we also need to consider related property.

Let us first measure Jim's transfer of value using **normal loss to donor rules.**

	£
Value of shares before gift	
(6,000 @ £8 each)	48,000
Value of shares after gift	
(4,000 @ £5 each)	(20,000)
Loss to Donor	£28,000

However, where **shares are held jointly** between a husband and wife, we measure the loss to donor **taking account of the related property rules**.

The effect of the related property rules is to treat Jim and Barbara's shares as one asset for IHT purposes. When measuring Jim's loss, we **also take account of the shares held by Barbara**. This is done as below:

	£
Value of shares before gift	
$\frac{6000}{9000}$ x value of joint holding	
$\frac{6000}{9000}$ x (9,000 x £12 each)	72,000
Value of shares after gift	
$\frac{4000}{7000}$ x (7,000 x £8 each)	(32,000)
Loss to Donor	£40,000

Before the gift, Jim had 6,000 shares. Barbara had 3,000 shares, so together their "related property" is 9,000 shares. Therefore, for IHT purposes, Jim is deemed to own **6/9ths of their joint shares**.

Therefore instead of looking at his 6,000 shares in isolation, we assume that Jim has **6/9ths of a 90% holding**. Shares that form part of a 90% holding are valued at £12 each at the date of the transfer. A 90% holding (i.e., 9,000 shares) in total would be valued at £108,000. Jim is deemed to have 6/9ths of these shares, so his 6,000 shares are treated as being worth £72,000.

Jim gave 2,000 of his shares away, so his personal holding goes down to 4,000 shares. Barbara still has her 3,000 shares, so together they have related property of 7,000 shares. After the transfer, Jim is deemed to have **4/7ths of a 70% holding**. Shares that form part of a 70% holding are worth £8 each. In total a 70% holding is worth £56,000. Jim's shares are deemed to be worth 4/7ths of £56,000 being £32,000.

We deduct the value of the shares after the transfer from the value of Jim's shares before the transfer to give a value transferred for IHT purposes of £40,000. This is **significantly more** than the value transferred ignoring the related property rules, so HMRC **will always use this higher figure.**

1.7 Related property – "non share" dispositions

S.161(3) provides for a **different method of valuing the transfer where the asset being given away is not shares**. These rules will therefore apply to disposals of assets such as chattels which may form part of a set and are therefore worth more when valued together.

Illustration 3

In 1990, Robert gave his daughter (Lisa) and his son-in-law (David) a set of 6 Andy Warhol prints as a wedding gift. He gave 4 to Lisa and 2 to David.

In July 2010, Lisa gave 1 of her prints to her son, Jack, on his 18th birthday. The value of the prints at the date of the gift were as follows:

1 print	£40,000
2 prints	£100,000
3 prints	£200,000
4 prints	£300,000
5 prints	£450,000
6 prints	£750,000

We will calculate Lisa's transfer of value for IHT purposes.

Where assets (other than shares) are owned jointly by husband and wife, and one of the spouses makes a chargeable transfer, the value transferred should be calculated as below.

£

Value before transfer		
£750,000 $\times \frac{300000}{300000+100000}$	(Note 1)	562,500
Value after transfer		
£450,000 $\times \frac{200000}{200000+100000}$	(Note 2)	(300,000)
Transfer of value		**£262,500**

Note 1: 6 prints are worth £750,000. Lisa has 4 of them.
4 prints are worth £300,000. David's 2 prints are worth £100,000.

Note 2: 5 prints are worth £450,000. Lisa has 3 of them.
3 prints are worth £200,000. David's 2 prints are worth £100,000.

1.8 Related property – additional points

An individual's property is related to that owned by his spouse or civil partner. Related property also includes similar assets **owned by a charity**, but only if two conditions are satisfied.

1. The charity must have **acquired the assets either from the donor or the donor's spouse;** and

IHTA 1984, s.161(2)

2. The assets must either be **owned by the charity** at the date of the transfer, or **have been held** by the charity **at any time in the previous 5 years.**

You are far more likely to come across related property in the context of similar assets owned by one's **spouse/civil partner.**

Example 1

Which of the following dispositions are treated as a transfer of value for IHT purposes?

		Yes ✓	No X
(a)	Gift of shares to son		
(b)	Payment of daughter's school fees		
(c)	Sale of a painting to art dealer		
(d)	Waiver of dividend in family company		
(e)	Purchase of Porsche from local garage		
(f)	Gift of house to a family trust		

Example 2

Julia owns 3 antique vases. Her husband Simon owns 1 vase. The 4 vases form part of a set.

Julia gives 1 of the vases to her son. The value of the vases at the date of the gift are:

1 vase	£1,000
2 vases	£3,000
3 vases	£6,000
4 vases	£10,000

Calculate Julia's transfer of value for IHT purposes.

Answer 1

	Transfer of value? Yes	No	
Gift of shares to son	✓		
Payment of daughter's school fees		X	(Maintenance of family)
Sale of painting		X	(No loss to donor)
Waiver of dividend		X	
Purchase of Porsche		X	(No loss to donor)
Gift of house to trust	✓		

Answer 2

Where assets (other than shares) are owned jointly by husband and wife, and one of the spouses makes a chargeable transfer, the value transferred should be calculated as below.

	£
Value before transfer	
$\frac{6000}{6000+1000}$ X £10,000 (Note 1)	8,571
Value after transfer	
$\frac{3000}{3000+1000}$ X £6,000 (Note 2)	(4,500)
Transfer of value	**£4,071**

Note 1: 4 vases are worth £10,000. Julia has 3 of them.
3 vases are worth £6,000. Simon's 1 vase is worth £1,000.

Note 2: 3 vases are worth £6,000. Julia now has only 2 of them (together worth £3,000). Simon still has 1 vase worth £1,000.