Receiving an inheritance

Becoming entitled to an inheritance from an estate brings with it mixed feelings. Sadness about the person you have lost but financial issues and opportunities.

Your financial and personal circumstances will have changed and it is important to seek support and good advice around the tax implications and decisions surrounding your inheritance. This could be an appropriate time to consider a new will and/or lasting power of attorney, which will ensure that your wishes for your own estate are taken into account, that provisions are made for those nearest and dearest to you, and also that your new situation is reflected.

Advice should always be taken on specific circumstances; however this information sheet is intended to highlight some of the more common tax considerations that could arise as a result of your inheritance.

1. Tax planning and deeds of variation

Receiving an inheritance can be the right time to explore your own tax planning options and opportunities.

You may wish to give away all or part of what you are entitled to receive in order to prevent increasing the overall value of your estate and in turn future inheritance tax (IHT) liability. If you do this by making a direct gift you would need to survive for 7 years for it to be excluded from your own estate for IHT purposes.

Instead of making a gift such as this, you could complete a "deed of variation". By a deed of variation, some or all of the cash or assets you were due to receive from the estate would pass to individuals chosen by you or even to a trust of which you are perhaps a potential beneficiary and/or a trustee.

So long as the deed of variation is completed within 2 years of the date that the person who left you the inheritance died, the gift of your entitlement could be treated for IHT and capital gains tax (CGT) purposes as if it had been made from the deceased's estate rather than by you personally.

This means that the value of the gift would therefore immediately be outside of your own estate for IHT. In addition, you could potentially benefit from assets if they were gifted to a trust without them being treated as part of your own estate for IHT purposes.

2. Income tax

If you are entitled to all or part of an estate and you are already a higher or additional rate taxpayer or are close to those levels, your share of the income received in the estate up to the value of assets or cash transferred to you in any particular tax year, will be subject to income tax, payable by you – executors only pay tax up to the basic rate.

As a general guide, for income tax all individuals have an annual tax-free allowance which means the first part of their income up to this amount is not taxable. The allowance starts at £11,000, but if your total income before tax is above £100,000 a sliding scale applies gradually reducing the allowance to nil.

In broad terms, the first £32,000 gross income above the annual tax-free allowance, known as the basic rate tax band, is taxable at 20%; up to £150,000 is taxable at 40%; and above £150,000 is taxable at 45%.

If there is a possibility that receiving the estate income may push you into a higher tax band and the administration period of the estate might span the end of a tax year (5 April), you need to let the person dealing with the estate know, so they can try to time any distributions of cash and/or assets from the estate to avoid you paying higher income tax rates.

3. Capital gains tax (CGT)

If assets to be sold in an estate are worth more than their value at the date of death (known as the probate value) it is worth considering how to achieve the best tax outcome.

Estates benefit from the normal annual CGT allowance for individuals, which is currently £11,100, for each of the tax year in which the death has occurred and the subsequent two tax years. For total gains on assets sold that are higher than this figure, after deducting any losses, CGT at a rate of 20%* is payable from the estate.

There are steps that can be taken if gains are likely to be in excess of the allowance, for example, by transferring the assets to the beneficiaries before sale. In such a situation, each beneficiary could use their own annual CGT allowance and any personal allowable losses, to offset the capital gains made over the probate value on a later sale. CGT would then be payable by the beneficiaries on the net gains at 10%* where, when added to their income, the total is within their basic rate tax band (explained above). An individual's CGT rate is 20%* only on the amount of gains above this band.

If an asset is passed by the beneficiary before sale to their spouse or civil partner, he or she will take it on with the probate value as the acquisition cost. Also, assets could, by a deed of variation, be passed to say the children to use their personal annual CGT allowances. The recipient's acquisition cost would again be the probate value.

It is therefore possible to make use of several sets of annual allowances, losses and unused basic rate tax bands to reduce or even eliminate the CGT payable on the sale.

If on the other hand assets go down in value after the date of death, it is possible for the executors to crystallise that loss and obtain an IHT refund. It is even possible, in relation to shares sold within 12 months, for the executors to sell them to secure IHT loss relief, and then for the beneficiary immediately to buy them back.

*The CGT rate is increased by 8% for gains on residential properties.

Summary

Receiving an inheritance could raise a number of issues which you may need to consider further. We are happy to talk these through with you and give you advice on the options available and which best suit your own personal situation. You may also wish to review overall financial arrangements including investments and pensions - this could of course be with your existing financial adviser, or, if you do not already have one, we could provide recommendations for advisers that would be suitable for you.

For further information please get in touch with your usual Lodders contact or via:

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