Inheritance tax (IHT) exemptions

Exemptions available during lifetime or on death

Gifts to certain recipients are completely exempt from IHT whether they are made during lifetime or on death. The main such exemptions include gifts to spouses or civil partners, to UK charities, to certain specified bodies for national purposes and to UK political parties (subject to certain conditions being met).

Exemptions available for lifetime gifts only

There are also a number of exemptions which only apply to gifts made during lifetime. These include:

- The annual exemption which permits lifetime gifts of up to £3,000 each year free from IHT. Any unused portion of the annual exemption from the previous year can be carried forward to the next year so that potentially, a maximum of £6,000 could be given away exempt from IHT in one tax year.

- The small gifts exemption that applies to outright gifts, which do not fall under any other exemption, of up to £250 per individual donee.

- Gifts made in contemplation of a marriage or civil partnership may also be exempt from IHT dependent on the amount and the donor's relationship to the donee. Gifts of up to £5,000 from each parent of the parties to the marriage or civil partnership are exempt. Grandparents or a more remote ancestor can give up to £2,500 and any other person up to £1,000. Also, the couple can give each other up to £2,500 as a wedding gift. The exemption is conditional on the ceremony actually taking place.

- Normal expenditure out of income exemption under which a gift of the donor's surplus income can be exempt where, after the gift has been made, they retain sufficient income to maintain their usual standard of living.

  This can be a very useful exemption as the surplus income can be given away in a tax efficient manner so preventing the donor's estate from increasing further by the accumulation of income.

  For the exemption to apply the gifts must be part of the donor's normal expenditure which means that they must be made on a regular basis. Also there must be a pattern of payments which can change, but it must be shown that it was intended for a pattern to exist and to remain for a period of time.

  The amount of the gifts do not have to be fixed, for example they could simply be for the amount of income left over after all household expenditure or care fees have been paid, and they do not have to be to the same person each time. There is no fixed minimum period to establish the relief.

- Gifts are not considered as transfers for IHT purposes when made for the maintenance of the family, specifically for a spouse/civil partner, a child whilst they are under 18 or in full time education, or any relative who is financially dependent on the person making the gift

  This rule is not strictly an exemption and is often overlooked. It can however mean that large gifts of capital could be made free of IHT.

Potentially exempt transfers (PETs)

Provided that a donor survives an outright gift to an individual, that is not covered by other exemptions, by seven years or more it will not be chargeable to IHT. If the donor were not to live for seven years from the gift, its value would be added to their estate to calculate the value for IHT purposes. There is no limit on the amount of the gift that can be made so theoretically a donor could give away substantial assets and, provided that they survive for seven years, there might be no IHT to pay from their estate.

Any gifts that become chargeable by virtue of the fact that the donor does not survive them by seven years would be set against their nil rate band allowance of £325,000 on death (2019/20), so that the amount that would be available to set against their estate would be reduced. If the gift was more than the nil rate band allowance so that there was tax to pay on it, taper relief would operate to reduce the IHT charge. Under this relief, if the donor survived the gift for between three and seven years, the IHT rate on the taxable part of the gift could be reduced to as low as 8%.

Importantly, for a gift to be effective for IHT purposes the donor must not be able to benefit in future from whatever they give away. If they were, they would be caught by the reservation of benefit rules under which they would be likely to be treated as still owning the asset that was given away. So, for example, an individual cannot give away their house and continue to live there rent free without it being subject to IHT when they die (such a plan could also lead to unfortunate capital gains tax consequences on the eventual property sale). If the donor were to give away their property or part of it and then pay a market rent to the donees throughout however, this would not be treated as a reservation of benefit and after seven years the house would no longer be part of their estate for IHT purposes.

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

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