Different legacies

Inheritance tax and trusts



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Natasha Warren provides a refresher course on the basic principles of estate tax

Key Points

What is the issue?

Dealing with the income tax and capital gains tax issues relating to the administration of an estate.

What does it mean to me?

Deciding whether an estate tax return is required or if the estate tax can be dealt with informally. Understanding the basic principles of how the tax is calculated in the administration period and the impact of the different types of legacies on the beneficiary's income tax position.

What can I take away?

An overview of how estates are taxed and highlighting potential reliefs and ways of saving tax.

The estate administration period starts on the day after the individual dies and generally ends once the residue of the Estate has been determined.

The personal representatives are responsible for completing tax returns to report the estate's income and capital gains during the admin period. If the admin period straddles more than one tax year then a tax return will be required for each tax year. Before any Tax Returns can be submitted, the personal representatives will need to contact HMRC to request a UTR for the Estate. The normal Self Assessment rules will apply to the submission of the Estate tax return and payment of tax.

In certain cases the admin period can be dealt with informally. This means that instead of submitting estate tax returns, the personal representatives can provide HMRC with a summary reporting the estate's income and gains during the admin period along with a computation of the tax payable. The income and gains over the whole of the admin period (even if the period straddles tax years) can be totalled for the purposes of the summary. Once HMRC have agreed the position they will issue a payslip to the Personal representatives so that the tax can be settled.

The informal procedure can be used if the following conditions are met:

- The value of the estate is less than £2 million;
- The total tax liability during the admin period is less than £10,000;
- The total proceeds from capital disposals during the any one tax year is less than £2.5 million;
- The admin period does not last more than two years; and
- HMRC do not regard the estate as complex.

For 2016/17 only, the personal representatives will not need to report the Estate income and pay the tax if the Estate's only income is savings income and its total liability is less than £100. This is a temporary rule introduced to avoid unnecessary compliance burden which would have resulted due to the change in interest and dividend tax.

Calculating the tax

Income tax

The calculation of the income tax position is relatively straightforward. The estate income is taxed at the basic rate of tax of 20% for non savings and savings income and 7.5% for dividend income. The personal representatives are not entitled to a personal, savings or dividend allowance.

The Estate is entitled to relief for any interest paid on a loan taken out for the purposes of settling the Inheritance tax. The relief is restricted to the interest paid on the first 12 months after the loan was made. This relief is given in the form of a deductible payment and will reduce non savings income then savings income then dividend income. There is no relief for any other expenses incurred in connection with dealing with the Estate's tax position.

Capital Gains Tax

For capital gains tax purposes, the personal representatives are deemed to have acquired the Estate's assets at probate value. Therefore the gain will be calculated as the difference between the sale proceeds and the probate value. On the appointment of an asset from the personal representatives to a beneficiary no chargeable gain will accrue and the beneficiary will be treated as acquiring the asset at probate value.

The personal representatives are entitled to a capital gains tax annual exemption for the year of death and the following two tax years. An additional deduction is available for the costs of obtaining probate. The deduction can be based on the actual costs of obtaining probate or the rules set out in SP 2/04. The Estate gains are taxed at 28% for residential property and 20% for any other gains.

The personal representatives will be entitled to Principal Private Residence relief if the property was the beneficiary's main residence immediately before and after the individual's death and that beneficiary is entitled is to at least 75% of the net proceeds of sale of the property.

The personal representatives may want to consider appointing assets to the beneficiary rather than selling them in order to utilise the beneficiary's annual exemption. If the beneficiary is a basic rate tax payer they can also take advantage of the lower rates of capital gains tax of 10% and 18%.

Any capital losses in the admin period are treated as normal and set off against capital gains in the same year and any excess losses are carried forward to future tax years in the admin period. Unfortunately, once the admin period has ceased any unused losses are wasted. There is no facility to carry back the losses to previous years nor can the losses be transferred to the beneficiaries.

To avoid the personal representatives wasting capital losses, they may want to consider appointing the assets to the beneficiary prior to sale so that the beneficiary can crystallise the loss and use this to offset against their own current year or future capital gains.

Although there are potential advantages of appointing assets to the beneficiary rather than disposing of them, it may not necessarily be practical to do so. For example, if an indivisible asset is left to more than one beneficiary or if an Estate has insufficient cash to settle the tax or liabilities, the personal representatives may have little choice but to dispose of the asset.

On a side note, in certain circumstances, where there is a loss on disposal by the personal representatives, post mortem relief can reduce the value of the asset used for calculating the inheritance tax liability (IHT) of the Estate. A claim for post mortem relief has the result of reducing the IHT payable on the Estate. In most cases the IHT would have already been paid by the personal representatives before the relief is claimed and therefore the claim will result in a repayment of IHT. As the main IHT rate of 40% is higher than the main capital gains tax rate of 20%, provided the value of the Estate exceeds the nil rate band, a claim for post mortem relief will usually result in a higher tax saving. The relief is available on disposals of land and buildings, quoted shares and assets which have been valued using the IHT related property rules provided the disposals are within certain time limits.

Beneficiaries tax position

Any income taxable on a beneficiary will be reported on a form R185. This form will report the net taxable income along with the basic rate tax credit of 20% for non savings and savings income and 7.5% for dividends. The beneficiary will then need to report this income and tax credit on their personal Tax Return and they will be liable to any higher or additional rate tax on this income.

The beneficiary’s taxable income will depend on the type of their legacy.

Specific legacy

If the beneficiary is entitled to an income bearing asset then the income from that asset will be taxable on the beneficiary from the date of death. Whilst the asset is held by the personal representatives, the personal representatives will pay tax on the arising income and therefore the beneficiary will be taxed receive a basic rate tax credit on the income. The beneficiary will only be assessed on the income once he has actually received it.

If the asset is not an income bearing asset then there are no income tax implications for the beneficiary.

Pecuniary legacy

Generally where a beneficiary is entitled to money there are no income tax implications. However, if the beneficiary has not received the money within 12 months of the date of death, then the personal representatives are usually required to pay interest to the beneficiary. This interest will be taxable income in the hands of the beneficiary. The personal representatives do not receive any relief for the interest paid.

Residuary legacy

The residuary beneficiary is entitled to all the Estate income excluding income which a specific legatee is entitled to and after allowable liabilities. Allowable liabilities include the income tax payable by the personal representatives and management expenses.

The beneficiary is taxed on the Estate income based on the payments made by the personal representative to them in the tax year. Any undistributed income at the end of the tax year will be carried forward to the next year and matched with payments in that year. Regardless of whether the beneficiary has received all of the residuary income, they will be taxed on all of the undistributed income in the tax year the admin period comes to an end. A payment includes the transfer of an asset and in this case the amount treated as paid equals the value of the asset at the date of transfer.

Where the beneficiary has an absolute residuary legacy they will receive income tax relief for any income which has already been charged to IHT. IHT would have been due on any accrued income at the date of death, for example accrued interest on a government bond or loan stock. The relief is calculated in accordance with ITTOIA 2005 s699 and the effect is that it restricts part of the beneficiary’s taxable income to basic rate tax only.