A guide to Inheritance Tax

STELLAR

For investment professionals only

Inheritance tax: the key points

What is inheritance tax?

Inheritance Tax (IHT) is charged on an individual's estate when they die, if they are domiciled or deemed domiciled in the UK. Domicile is a legal and tax concept that refers to your permanent home.

If you are UK-domiciled at the time of death, Inheritance Tax applies to your worldwide assets, regardless of where they are held. If you are domiciled outside the UK, the tax is generally limited to assets situated in the UK.

Although the rules are complex, Inheritance Tax is often considered a planning-driven tax, as effective estate planning can reduce, and in some cases eliminate, liability.

What is an estate?

A person's estate consists of all assets they own at the time of death, after any debts and liabilities have been deducted.

If you are married or in a civil partnership, you can usually leave your entire estate to your spouse or civil partner without Inheritance Tax being payable. However, if you leave assets to other beneficiaries, such as family or friends, those assets may be subject to tax depending on the overall value of the estate.

What is the Inheritance Tax threshold?

Each individual benefits from a nil-rate band of £325,000. Estates valued at or below this amount are not subject to Inheritance Tax. Where the estate exceeds this threshold, the excess is typically taxed at 40%.

What assets are included in an estate?

An estate is made up of a wide range of assets, including property such as your main home and any additional properties you own. It also includes savings, investments (including ISAs, which are not exempt from Inheritance Tax), other personal possessions, and the value of life insurance policies held in your name. From 6 April 2027, certain pension assets will also be brought into scope for Inheritance Tax purposes.

How to calculate the value of an estate

To determine the value of an estate for Inheritance Tax purposes, all assets are added together, including certain gifts made during the seven years before death. From this total, any outstanding debts such as mortgages, loans, and credit card balances are deducted.

In addition, certain items can be excluded from the calculation, including qualifying lifetime gifts, charitable donations made in the will, and reasonable funeral expenses.

Inheritance Tax liability

If the value of the estate is £325,000 or less, no Inheritance Tax is due. However, it is still important to monitor the value of assets over time, as changes in circumstances could result in a future liability.

Where the estate exceeds £325,000, the nil-rate band is fully used and the remaining value is subject to Inheritance Tax at 40%.

For example, if an individual dies leaving an estate worth £500,000, the first £325,000 is tax-free. The remaining £175,000 is taxed at 40%, resulting in a tax bill of £70,000.

Historical context

Modern Inheritance Tax has its origins in 1894, when the government introduced estate duty as a tax on the capital value of land. Over time, this system evolved into the current Inheritance Tax regime.

How marital status affects Inheritance Tax

The application of Inheritance Tax can vary depending on marital status. For single individuals, if the value of the estate exceeds £325,000, the excess is generally subject to Inheritance Tax at up to 40%.

Beneficiary

A beneficiary is the individual or group who receives an inheritance when someone dies, or who benefits from a trust arrangement.

Married or in a civil partnership

If you are married or in a civil partnership, any assets left to your spouse or civil partner are generally transferred without Inheritance Tax being payable. In addition, such transfers do not use up your nil-rate band.

However, if you leave assets to someone other than your spouse or civil partner and your estate exceeds £325,000, the excess may be subject to Inheritance Tax at up to 40%.

When the surviving spouse or civil partner later dies, their estate is assessed for Inheritance Tax in the usual way, taking into account any available allowances.

Widowed individuals

When a person dies, any unused nil-rate band can be transferred to their surviving spouse or civil partner. This means that, in some cases, the surviving partner may benefit from a combined nil-rate band of up to £650,000.

For example, if one spouse leaves their entire estate to the other on death, the surviving spouse may inherit both nil-rate bands, depending on circumstances.

Unmarried couples

Unmarried couples are treated as single individuals for Inheritance Tax purposes. Each person has their own nil-rate band of £325,000, and these allowances cannot be combined on death.

From 6 April 2026, an additional allowance relating to Business Relief and Agricultural Property Relief (APR) was introduced, set at £2.5 million. This allowance is separate and is not transferable between spouses.

Example of Inheritance Tax after the death of a spouse

John Smith dies and leaves his entire £500,000 estate to his wife, Jane.

Jane then holds combined assets of £950,000, which includes her own £450,000 plus the inherited £500,000.

After applying the combined nil-rate band of £650,000, Jane has a taxable estate of £300,000. This amount is taxed at 40%, resulting in an Inheritance Tax liability of £120,000.

Residence nil-rate band

A further Inheritance Tax allowance, known as the residence nil-rate band, was introduced in 2015. Although it is sometimes suggested that this creates a £1 million nil-rate band, the reality is more nuanced and depends on individual circumstances.

Inheritance Tax and property

Rising property prices have meant that more estates are now subject to Inheritance Tax, as the value of the family home alone can exceed the nil-rate band. Despite this, the standard nil-rate band of £325,000 has been frozen until at least 2031.

To address this, the Government introduced an additional allowance of up to £175,000 in 2015, which applies when passing a main residence to direct descendants such as children or grandchildren. This allowance is also frozen until at least 2031. However, forecasts indicate that HM Revenue & Customs Inheritance Tax receipts are still expected to increase.

Although the intention of the residence nil-rate band is to reduce the tax burden on family homes, relatively few estates are able to benefit fully from a combined £1 million threshold.

Key features of the residence nil-rate band

The residence nil-rate band applies where an individual dies on or after 6 April 2017 and leaves a qualifying residential property to direct descendants.

It was phased in and reached its maximum level of £175,000 per person for deaths occurring after 6 April 2020, or £350,000 for married couples and civil partners.

When combined with the standard nil-rate band, this can potentially allow up to £1 million per couple to pass free of Inheritance Tax. However, the allowance remains frozen at £175,000 per person until at least 2031.

Who can claim the allowance?

The residence nil-rate band is primarily intended to benefit married couples and civil partners, allowing them to pass on up to £1 million in combined assets, including the family home, without incurring Inheritance Tax, provided the relevant conditions are met.

However, not everyone will benefit, and there are a few rules to be aware of:

- As the name suggests, this allowance will apply where the person who has died owned a property that was at one time their home.
- It will also only apply if the property is being left to the deceased's direct descendants (children or grandchildren).
- It won't help you if you don't own a property. Also, anyone without direct descendants, or who wishes to leave their home to someone other than a direct descendant, cannot benefit.
- Anyone without a property worth at least £175,000 per person, or £350,000 per couple, will only partially benefit.
- The residence nil-rate band will be reduced by a rate of £1 for every £2 by which the estate exceeds £2 million. This means that larger estates may not benefit.
- Anyone who disposed of their property before 8 July 2015 – for example, because they are in residential care or living with their children – will not benefit from the allowance at all.

Spousal transfers

The nil-rate band is structured so that when the first spouse or civil partner dies and leaves their entire taxable estate to the surviving partner, the unused nil-rate band can be transferred. As a result, the estate of the surviving spouse may benefit from a combined nil-rate band of up to £650,000, effectively doubling the individual allowance.

A similar principle applies to the residence nil-rate band. When the second spouse or civil partner dies, their estate may be able to claim a combined residence nil-rate band, provided the first partner did not fully use it. The maximum available relief is limited to the higher of the allowance available at the time of the second death or the value of the property being passed on.

Key points on the residence nil-rate band

Although the residence nil-rate band is sometimes described as enabling couples to pass on up to £1 million free of Inheritance Tax, this is only possible where several conditions are met.

In practice, both spouses must have died after 6 April 2020, when the maximum allowance was fully in place. In addition, the surviving partner must own a home worth more than £350,000 at the time of death, and that property must be left to direct descendants such as children or grandchildren. Finally, the total value of each estate must be below £2 million, otherwise the allowance may be reduced or withdrawn.

Pensions and Inheritance Tax

Following changes announced in the Autumn 2024 Budget, the Inheritance Tax treatment of pensions depends on whether death occurs before or after 6 April 2027.

There are broadly two main types of pension, excluding the State Pension. A Defined Benefit pension provides a guaranteed income based on a proportion of final salary, usually payable for life. In most cases, this income ends on death, although a surviving spouse may continue to receive a portion. These schemes generally cannot be passed on, although it may sometimes be possible to exchange benefits for a lump sum, which requires careful financial advice.

A Defined Contribution pension works differently. Contributions build up a pension pot over time, which can be accessed at retirement. Typically, up to 25% can be taken tax-free, with the remainder used to provide retirement income, either through drawdown or by purchasing an annuity. While annuities usually end on death, drawdown arrangements may allow any remaining pension savings to be passed to beneficiaries.

From 6 April 2027, unused Defined Contribution pension funds are expected to fall within the scope of Inheritance Tax, although transfers between spouses or civil partners will remain exempt.

Age at death and pension taxation

The tax treatment of inherited pension savings also depends on the age at which death occurs.

If an individual dies before the age of 75, beneficiaries can usually draw from the inherited pension without paying income tax. However, if death occurs after the age of 75, any withdrawals made by beneficiaries will generally be subject to income tax at their marginal rate, which may be 20%, 40%, or 45%.

Any pension income taken during lifetime is subject to income tax, and any remaining unused pension funds may form part of the taxable estate on death.

Gifting to reduce the value of an estate

It is possible to reduce the value of an estate by making lifetime gifts, although specific rules and exemptions apply.

Gifts between spouses or civil partners are generally exempt from Inheritance Tax. In addition, individuals benefit from an annual exemption of £3,000, which can be used each tax year. Any unused allowance can be carried forward for one year only.

Small gifts of up to £250 per person are also exempt, provided the £3,000 annual exemption has not already been used for the same individual in the same tax year.

There are also exemptions for wedding or civil partnership gifts. Parents can gift up to £5,000, grandparents up to £2,500, and others up to £1,000. Gifts between spouses remain fully exempt.

Charitable donations are also exempt from Inheritance Tax when made to recognised organisations such as charities, universities, national museums, the National Trust, political parties, and certain housing associations.

Gifts from surplus income

Certain gifts may be exempt if they are made regularly from surplus income and do not affect the donor's standard of living. These are known as normal expenditure out of income.

The definition of "normal" depends on the individual's circumstances, but HMRC generally expects to see a consistent pattern of gifting. Where this exemption applies, the gifts are immediately outside the estate for Inheritance Tax purposes and do not use up the nil-rate band.

Potentially exempt transfers and the seven-year rule

Other lifetime gifts may be treated as potentially exempt transfers. These become fully exempt from Inheritance Tax if the donor survives for seven years after making the gift.

If the donor dies within seven years, the value of the gift may be added back into the estate for tax purposes, and Inheritance Tax may be payable by the recipient.

If death occurs between three and seven years after the gift, taper relief may reduce the amount of tax due. However, this relief generally only has an impact where the total value of lifetime gifts exceeds the nil-rate band within the relevant period before death.

Inheritance tax taper relief table

Time between making gift and death	Rate of taper relief
4-5 years	40%
5-6 years	60%
6-7 years	80%
Over 7 years	No inheritance tax due

Keeping a record of lifetime gifts

You are not legally required to keep a record of gifts made during your lifetime. However, doing so is strongly recommended. After your death, the executors responsible for administering your estate must account for any gifts made within the relevant tax period, which can extend up to fourteen years in certain circumstances.

Maintaining clear records helps ensure that the administration of your estate is more efficient and reduces the risk of delays or errors.

Key considerations when making gifts

Making lifetime gifts can be an effective way to reduce Inheritance Tax liability, but it also involves important trade-offs.

Once a gift is made, the donor gives up ownership and control of those assets. In addition, there is uncertainty around future financial needs, making gifting a significant long-term decision.

The seven-year rule can also be a limitation, particularly for older individuals or those in poor health, as it may take a long period for gifts to fall outside the estate for tax purposes.

For these reasons, keeping accurate records of all lifetime gifts is important, as it assists those who will later administer the estate.

Equity release schemes

In many cases, a significant proportion of an individual's wealth is tied up in their home. Equity release schemes have therefore become a way of accessing this capital during retirement.

These arrangements typically involve either releasing a portion of the property's value while continuing to live in the home, or taking out a lifetime mortgage that is repaid from the value of the property after death.

Both options reduce the value of the estate for Inheritance Tax purposes, as the loan, together with any accrued interest, is repaid from the sale of the property on death. If the funds released are spent during lifetime, this can further reduce the taxable value of the estate.

The capital released can be used as retirement income or potentially gifted to others, which may also reduce the value of the estate, provided the individual survives seven years from the date of the gift.

While equity release can be suitable in some circumstances, it also carries significant risks. It is important to seek independent financial advice and discuss the decision with family members before proceeding.

Setting up a trust

Trusts are legal arrangements that allow assets to be managed and distributed according to specific instructions. They are often used to provide greater control over how and when beneficiaries receive assets, while also managing potential Inheritance Tax exposure.

Trusts are commonly used to preserve wealth across generations and can be tailored to reflect individual wishes. For example, they may be used where assets are intended for children or grandchildren but are not to be accessed until they reach a specified age. They can also be used to impose conditions on how assets are used, or to provide income to one person during their lifetime before passing capital to another beneficiary.

Limitations of trusts

Although trusts provide flexibility and control, they can be complex to establish and manage. Since 2006, certain Inheritance Tax charges have applied both when assets are placed into trusts and when they are transferred out to beneficiaries.

As a result, placing significant wealth into trust may not always be tax-efficient.

In some cases, assets placed into trusts during lifetime are also subject to a seven-year rule, similar to outright gifts. If the settlor dies within this period, the value of the trust assets may be included in their estate for Inheritance Tax purposes if the estate exceeds the nil-rate band.

The legal framework governing trusts is long-established.

Types of trust	How it works
Discretionary trusts	Usually set up to provide money for a group of beneficiaries – for example, children or grandchildren – but responsibility for managing the assets in the trust is given to someone else: the trustee. For the purposes of inheritance tax, the assets in a discretionary trust are outside of the estate, provided the person who set up the trust lives more than seven years. However, inheritance tax can be payable (1) at the outset, (2) every ten years (known as 'periodic' charges) or (3) when trust assets are paid out to beneficiaries.
Discounted gift trusts	These involve a person making a gift to a trust while retaining the right to pre-agreed payments of capital from the trust during their lifetime. For inheritance tax purposes, the gift is valued after applying a 'discount' based on the person's age, sex and health. The effect is that they can immediately reduce the value of their taxable estate by the amount of the 'discount' applied to their gift to the trust, while retaining the benefit of the regular payments from the trust during their lifetime. The discount is given because the trust will be paying amounts out to the owner for the rest of their life. But if these amounts are not spent, they will again be subject to inheritance tax when the owner dies.
Immediate Post Death Interest trusts	These ensure that one beneficiary receives a 'life interest' in the assets in the trust. A life interest could be the right to live in a house, or the right to receive rent from that property throughout the rest of their lifetime. The capital held in the trust has to be passed to different beneficiaries in the future. Here's an example: a husband has children from a first marriage but has since remarried. He can set up a trust in his will, naming his second wife as the lifetime beneficiary (also known as the 'life tenant'). His wife can then receive an income from the trust for the rest of her life. When she dies, the capital in the trust will pass to her husband's children from the first marriage. When it comes to inheritance tax, the assets in the trust, not just any unspent income from it, are classed as part of the lifetime beneficiary's estate. When they die, the value of the trust is part of their 'death estate', so it may use up some or all of their nil-rate band and inheritance tax may be payable.
Loan trusts	Typically, a person sets up a loan trust with themselves as the trustee, for the benefit of someone else. The trustee makes a loan to the trust which is often repayable on demand. They are able to invest the loan capital in order to generate growth for the trust, and ultimately the beneficiaries, over the long term. The growth within the trust is immediately exempt from inheritance tax.

Taking out life insurance to pay Inheritance Tax

There are two main types of life insurance policies that can be used to help cover a potential Inheritance Tax liability: whole-of-life assurance and term insurance.

Whole-of-life assurance is designed to provide a guaranteed payout whenever death occurs. The policyholder selects a sum assured, and upon death, this amount is paid to beneficiaries, who can then use it to settle any Inheritance Tax due to HMRC.

Term insurance, by contrast, provides cover for a fixed period. A level-term or decreasing-term policy pays out a lump sum if death occurs within the specified term. This can be particularly useful where individuals have made significant lifetime gifts and are concerned about dying within the seven-year period during which those gifts may still be included in their estate. The policy proceeds can then be used to meet any resulting tax liability.

Insurance becomes more expensive with age and typically requires medical underwriting, which can make it less accessible for some individuals. For this reason, it is often useful to view life insurance as a way of pre-funding a potential Inheritance Tax liability through regular premium payments.

Most life insurance policies are included in the taxable estate unless they are written into trust. When placed in trust, the payout falls outside the estate for Inheritance Tax purposes. Due to the complexity involved, professional financial advice is strongly recommended when considering this option.

It is important to note that life insurance does not reduce the amount of Inheritance Tax due; it simply provides a means of funding the liability.

Investments in Business Relief (BR)-qualifying companies

Business Relief is a valuable Inheritance Tax relief that can allow certain investments to be passed to beneficiaries with reduced or no tax liability.

Originally introduced as Business Property Relief in the Finance Act 1976, the relief was designed to support the continuation of family businesses across generations without a significant Inheritance Tax burden. Over time, it has been extended to encourage investment in qualifying trading businesses, including those that are not directly managed by the investor.

Today, Business Relief is often used as part of wider estate planning, with investments typically made in unquoted trading companies or those listed on the Alternative Investment Market (AIM). These investments may offer Inheritance Tax advantages in return for higher investment risk.

Why invest in BR-qualifying companies?

One key advantage is the speed at which Inheritance Tax relief can be achieved. Unlike lifetime gifts or trust arrangements, which generally require seven years to fall outside the estate, qualifying Business Relief investments may become eligible for relief after two years, provided they are still held at the time of death.

Another benefit is flexibility. Investors retain control of their capital and can sell their investment if needed. However, once sold, the funds will no longer qualify for relief.

In addition, these investments are relatively straightforward compared with trusts or life insurance arrangements, as they do not typically involve complex legal structures or medical underwriting.

How BR investments work

Some investment managers offer portfolios made up of companies that qualify for Business Relief, such as AIM-listed or unquoted trading businesses. These portfolios invest in underlying companies expected to meet HMRC's qualifying criteria.

Provided the investment has been held for at least two years and remains qualifying at the time of death, it can generally be passed to beneficiaries free from Inheritance Tax.

For married couples and civil partners, a joint ownership structure may allow the two-year qualifying period to continue without resetting if assets are transferred between them.

From 6 April 2026, changes to the regime introduce a £2.5 million Individual Business

Relief and Agricultural Property Relief allowance for unquoted qualifying assets, with relief at 100% within that allowance and 50% on amounts above it. AIM-listed shares fall outside this allowance and generally attract 50% relief regardless of value.

Risks of BR investments

These investments carry significant risk. The value of capital can fall as well as rise, and investors may not recover the full amount invested. Unquoted shares in particular are considered high risk.

Tax legislation and HMRC interpretations may also change over time, affecting eligibility for relief. In addition, companies must continue to meet qualifying conditions, or relief may be lost.

Liquidity can also be limited, particularly for AIM-listed and unquoted shares, meaning it may be difficult to sell holdings quickly or at expected values.

Key considerations

Not all companies qualify for Business Relief. For example, companies listed on the main London Stock Exchange are generally excluded. Qualifying companies must typically be trading businesses and not primarily investment-based.

They must also avoid certain activities such as dealing in land, property, or financial investments.

Given the complexity and risk involved, specialist advice is strongly recommended when selecting BR-qualifying investments.

Business Relief allowances

Every individual benefits from a nil-rate band of £325,000 and, where applicable, a residence nil-rate band of £175,000. Unused allowances can generally be transferred between spouses and civil partners.

From 6 April 2026, an additional Individual Business Relief Allowance of £2.5 million applies to qualifying unquoted business and agricultural assets, offering 100% relief within that threshold. Amounts above this level receive 50% relief. AIM-listed shares are excluded from this allowance and continue to receive 50% relief.

For married couples, combined Business Relief and Agricultural Property Relief allowances may reach up to £5 million, enabling qualifying assets to pass with full or partial relief depending on value and structure.

ISAs and Inheritance Tax

Although Individual Savings Accounts (ISAs) are tax-efficient during lifetime, they can become subject to Inheritance Tax on death. This can result in a significant tax liability where large ISA portfolios have been built up over time.

For example, an ISA portfolio worth £100,000 could potentially create a £40,000 Inheritance Tax liability if not properly planned for.

ISAs invested in BR-qualifying assets

Since 2013, it has been possible to hold AIM-listed BR-qualifying shares within an ISA. Where qualifying conditions are met, these investments may benefit from Inheritance Tax relief after two years, similar to other Business Relief assets.

From 6 April 2026, AIM BR-qualifying ISAs attract 50% Inheritance Tax relief.

Making a will

A will is essential if you wish to control how your assets are distributed after your death.

It allows you to specify who inherits your estate, appoint executors to manage your affairs, and, where relevant, appoint guardians for minor children. A will also clarifies what should happen if intended beneficiaries predecease you.

Although it is possible to draft a will independently, professional advice from a solicitor, tax adviser, or financial adviser is recommended to ensure it is legally valid and accurately reflects your wishes.

Without a valid will, your estate is distributed under intestacy rules, which may not reflect your intentions. In some cases, this can result in unintended beneficiaries or, where no relatives exist, assets passing to the Crown.

For this reason, it is important to review your will regularly, particularly after major life events such as marriage, divorce, the birth of children, or moving home, and to ensure it is stored securely but remains accessible when needed.

Get in touch

We’re here to help

Investors

We recommend you speak to a Financial Adviser in the first instance, as we cannot offer investment or tax advice.

If you have any other questions please contact us on 020 3195 3500 or email us at enquiries@stellar-am.com

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