THE TAX SHOP GROUP — CLIENT GUIDE

How Inheritance Tax Actually Works

A plain-English guide to the UK inheritance tax system, the key thresholds, and the main planning tools available. Updated for the 2026/27 tax year.

What inheritance tax is

Inheritance tax (IHT) is charged on the value of a person's estate when they die. The estate includes everything they own — property, savings, investments, business interests, pensions (which are expected to be included in estates for IHT from April 2027 under current legislation), and personal possessions — minus any debts and funeral expenses.

The standard rate is generally **40%** on the value of the estate above the available tax-free thresholds. If at least 10% of the net estate is left to charity, the rate drops to **36%**.

The tax-free thresholds

There are two main allowances that reduce or eliminate the tax charge:

Allowance	Amount	Notes
Nil-rate band (NRB)	£325,000	Frozen since 2009, frozen until April 2031
Residence nil-rate band (RNRB)	£175,000	Applies when a home passes to direct descendants

A single person may therefore be able to pass up to **£500,000** free of IHT if their home goes to children or grandchildren. A married couple or civil partners can usually combine both allowances — up to **£1,000,000** between them, subject to the relevant conditions being met.

> The RNRB tapers away for estates worth more than £2,000,000. For every £2 that the estate exceeds £2,000,000, £1 of RNRB is lost.

What is exempt

Several types of transfer are completely exempt from IHT:

- **Transfers between spouses or civil partners** — unlimited, no IHT at all
- **Gifts to UK charities** — fully exempt
- **Annual exemption** — £3,000 per year (can carry forward one unused year)
- **Small gifts** — £250 per person per year
- **Wedding gifts** — £5,000 from a parent, £2,500 from a grandparent, £1,000 from anyone else
- **Normal expenditure out of income** — regular gifts made from surplus income (no monetary limit, but strict conditions apply)

The seven-year rule

Gifts made during your lifetime are called **potentially exempt transfers (PETs)**. If you survive for seven years after making the gift, it leaves your estate entirely and bears no IHT.

If you die within seven years, the gift is brought back into the IHT calculation. However, **taper relief** reduces the tax charge on gifts made more than three years before death:

Years before death	Tax charged
0 – 3 years	100% (full 40% rate)
3 – 4 years	80%
4 – 5 years	60%
5 – 6 years	40%
6 – 7 years	20%
Over 7 years	0% — fully exempt

Business and agricultural relief

Business Property Relief (BPR) and Agricultural Property Relief (APR) can reduce or eliminate IHT on qualifying business assets and farmland.

From **6 April 2026**, a combined cap applies:

- **100% relief** on the first £2.5 million of qualifying BPR/APR assets per person

- **50% relief** on qualifying assets above £2.5 million (effective IHT rate of 20% on the excess)
- Married couples each have their own £2.5 million allowance

Before April 2026, BPR and APR had no cap — any qualifying business, regardless of value, could receive full relief. This change may create new IHT liabilities for business owners with qualifying assets above £2.5 million.

How trusts fit in

A discretionary trust allows assets to be held for the benefit of named people (beneficiaries) while trustees — who may include the person who set up the trust — retain control over when and how distributions are made.

Trusts have their own IHT charges:

- **Entry charge** — 20% on transfers above the nil-rate band (half the 40% estate rate)
- **Ten-year charge** — up to 6% of the trust fund above the available nil-rate band
- **Exit charges** — when assets leave the trust for beneficiaries

Given that these charges may be lower than the 40% inheritance tax rate that could apply if the same assets remained in the estate, trusts remain a popular IHT planning tool.

A simple worked example

Without planning

Margaret dies with an estate worth £1,200,000 (including her home, worth £400,000, passing to her daughter). She is a widow and her late husband's nil-rate bands were unused.

- Combined NRB: £325,000 + £325,000 = £650,000
- Combined RNRB: £175,000 + £175,000 = £350,000
- Total tax-free amount: £1,000,000
- Taxable: £200,000
- **IHT due: £80,000** (40% of £200,000)

With planning

If Margaret had made gifts of £200,000 to her daughter eight years before death, the estate at death would be £1,000,000 — exactly covered by the combined allowances. **IHT due: £0.**

What to do next

If any of the following apply to you, an IHT review may be worthwhile:

- Your estate (including your home, pensions, and any business interests) exceeds £325,000
- You own a business valued above £2.5 million
- You have not reviewed your will or estate planning in the last three years
- You want to pass wealth to the next generation while retaining some level of control

A review does not commit you to any particular course of action. It helps you understand your current position and the planning options available.

> Inheritance tax planning is complex and depends on individual circumstances, including the terms of wills, ownership structures, and the availability of reliefs and exemptions. Tax legislation may change, and professional advice should be obtained before taking action.

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