4 ways to reduce your Inheritance Tax bill

Famously, the only sure things in life are death and taxes. And inheritance tax – known as IHT or, more dramatically, the death tax – remains one of the most divisive and debated tax topics in the UK. It certainly gives 'jam or cream first?' a run for its money.

Whatever your views on IHT, it needs thinking about – all the more because the UK is in the top ten of countries with the highest inheritance tax rates in the world. The inevitability of this tax for many families makes good estate planning a must.

Inheritance tax – the origin story

The earliest version of inheritance tax was introduced in 1694 as Probate Duty, to help pay for all Britain's wars.

It has since seen several revisions and evolutions over the centuries, but IHT as we know it today was introduced in 1986.

It applies to estates valued above a certain threshold (currently £325,000), at a standard rate of 40%. That £325,000 allowance is known as the nil-rate band. Various additional tax allowances and reliefs are also available. These include the Residence Nil-Rate Band, which grants eligible estates an extra allowance of up to £175,000 (on top of the £325,000) if you give your main home to your children or grandchildren.

Fiscal drag – a villain appears

But there is a villain in this story: fiscal drag. This is when you end up paying more tax over time because the government freezes tax bands rather than adjusting them upwards for inflation. If these tax bands remain frozen but your pay increases, eventually you'll be "dragged" up into the higher tax brackets. It's also known as the "stealth tax".

IHT nil-rate bands have been frozen since 2009. Moreover, unused pension funds will be included in IHT calculations from April 2027. Taking all this together, even quite modest estates are in line to pay this tax. This means tax and estate planning is more crucial than ever to ensure more of your hard-earned wealth is passed on to loved ones.

4 ways to reduce your inheritance tax bill

We might not be able to live forever – but, we do have four ways for you to reduce your inheritance tax bill.

1. Deed of variation

What is a deed of variation?

This is a legal document that lets people make changes to someone's will after they've passed away.

It must be done within two years of a person's death, and everyone affected by the changes needs to agree to the new plan.

How can a deed of variation reduce an inheritance tax bill?

There are a couple of ways in which a deed of variation can directly reduce the inheritance tax bill on an estate.

Firstly, assets which have been left to non-exempt beneficiaries like children/grandchildren, could be redirected to a surviving spouse. This would then mean the legacy qualifies under the spousal exemption for inheritance tax purposes, and no IHT would be payable.

Separately, a deed of variation can also be used to redirect a legacy to a charity. A gift to a charity is fully exempt from inheritance tax. Furthermore, if an individual leaves 10% of their net estate to a charity, the rate of IHT their estate will pay reduces from 40% to 36%.

Lastly, a deed of variation can also be used to skip a generation, thus avoiding a scenario where receiving a legacy actually increases the inheritance tax liability on a recipient's estate. This strategy is particularly useful if the original recipient is elderly and likely to pass away in the near future.

2. Business Relief investments

What are Business Relief investments?

If we think of Business Relief as a shield against inheritance tax, then Business Relief investments are any qualifying business assets that you hold that are eligible for protection. These can include shares in companies not listed on a recognised stock exchange, companies listed on the Alternative Investment Market (AIM), and business assets.

How do Business Relief investments help with estate planning?

A £1 million per person allowance will apply to Business Relief investments from April 2026 (this £1 million allowance doesn't apply to AIM shares). In practice this means that only the first million will qualify for business relief at 100%. Anything above this £1 million allowance will be subject to relief at 50%, which is an effective tax rate of 20% (half of the standard 40% IHT rate)

With upcoming changes to inheritance tax savings on AIM shares and Business Relief as previously mentioned, there's still quite a bit of uncertainty, with further changes to the rules still possible. If you have the time and flexibility, it might be worth waiting to see how things pan out before going down this route.

Both AIM shares and Business Relief investments are considered high-risk financial products, so they might not be suitable for all investors. A financial planner will be able to help you weigh up the pros and cons of these investments and see if they're suitable for you. They'll also be able to help you with tax and estate planning and to identify alternatives if these don't work for you.

3. Investing in AIM shares

What are AIM shares?

These are shares listed on the Alternative Investment Market (AIM), a vehicle on the London Stock Exchange (LSE) for smaller companies that are growing quickly. They aren't big enough yet to be listed on the LSE's main market.

How do AIM shares help with estate planning?

Business Relief on AIM shares is reducing to 50% from 6 April 2026. You can think of Business Relief as a special rule that protects certain business assets from being subject to the usual IHT rate of 40% after you pass away. This means that more of your wealth is passed on to your loved ones.

It's also important to note that investing in smaller, growing companies does mean that your investment can be more volatile. AIM shares can be more volatile than more established shares on a recognised stock exchange, this means they can rise and fall more sharply. AIM shares are a high-risk investment, and you should recognise that your capital is at risk and you may not get back what you invest.

So, while AIM shares can be helpful for tax planning purposes, you still need to look at your overall financial situation and financial goals before making a decision.

4. Gifts from surplus income

What are gifts from surplus income?

This is money you have left over after paying for your regular living expenses. It should come from your salary, wages, interest, dividends, pension income or rental payments if you own a property (rather than capital, like investment bonds, ISAs or investment accounts).

There are a few conditions that need to be fulfilled to be able to use this rule. Gifts should be given regularly rather than as a one-off, the money gifted should come from income (not capital), and the gift giver should be able to maintain their usual standard of living after making the gifts.

How do gifts from surplus income help with estate planning?

Gifting from surplus income can be a really effective way of immediately reducing the size of your estate for inheritance tax purposes. This is because gifts that qualify under this exemption are not subject to the normal seven-year rule, which stipulates that you must live for seven years after making a gift, in order for it to be outside of your estate for inheritance tax purposes.

If you make a gift under this exemption, it could be immediately exempt. This means that even if you were to pass away within seven years, the gift would not be subject to inheritance tax. This makes this exemption particularly useful for older clients, who are worried about living for seven years after gifting.

What are the rules?

In order for gifts to qualify under this exemption, there are three conditions:

1. The gift must form part of your normal expenditure.
2. The gift must me made out of income (not capital).
3. The gift leaves you with enough income to maintain your normal standard of living (Please note this condition must be satisfied without resorting to the use of capital).

Tax planning with gifts from surplus income

Gifts from surplus income can be a very powerful exemption, and it's a strategy that's quite underused as many people don't know about it. With pensions becoming subject to inheritance tax from April 2027, it's something that you might want to think about for your own tax and estate planning.

However, it's important to note that this exemption is incredibly complex, as it involves detailed record-keeping. A financial planner can provide assistance with this exemption, to help ensure you remain compliant with HMRC's requirements.

Lastly, whatever your situation, whether you're just starting to think about your legacy or you want to ensure your existing arrangements are tax efficient, it's worth exploring all the options available to you. Inheritance Tax planning is a complex beast, and our financial planners are here to help.

Ready to explore your options? Contact us