TECHNICAL SALES BRIEFING

ORDER OF GIFTS
TRANSFERS AND THE 14 YEAR TRAP

KEY POINTS

- The order in which chargeable lifetime transfers (CLTs) and potentially exempt transfers (PETs) are made can, in certain circumstances, have a marked effect on future tax liabilities
- It would normally be prudent, where both forms of transfer are being considered at the same time, to make the CLT at least a day before the PET. This Technical Sales Briefing uses fictional examples to show why this is the case
- The order of transfers could be particularly relevant where consideration is being given to investment into a discounted gift trust scheme (DGT) using a combination of discretionary and absolute trust versions.

INTRODUCTION

Where an individual is contemplating making both a CLT and a PET at around the same time, it is important to consider what order to make them in. The order in which they are made can affect the amount of inheritance tax (IHT) that may be payable in the future.

This point can be especially important when we look beyond the usual seven year clock and consider the impact of an IHT principle called 'cumulation' i.e. the IHT calculations produce a cumulative tax result whereby the previous transfers can impact the taxation of later transfers.

This briefing looks at various issues and scenarios around the order of making gifts and attempts to explain what steps can be taken to help ensure the most beneficial result for all.

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THE INTERACTION OF CLTS AND PETS

Where both types of transfer are being made at broadly the same time, it would normally be preferable to make the CLT at least one day before the PET. If the PET is made prior to the CLT, and death occurs within 7 years, the PET will become chargeable and will affect not only the amount of the charge on the CLT, but also the subsequent 10 yearly anniversary charge (also known as the periodic or principal charge) and exit charges in respect of the trust created by the CLT. Further, if there is any immediate lifetime tax on the CLT, the annual exemption will be available to reduce this which may be wasted if allocated to the PET.

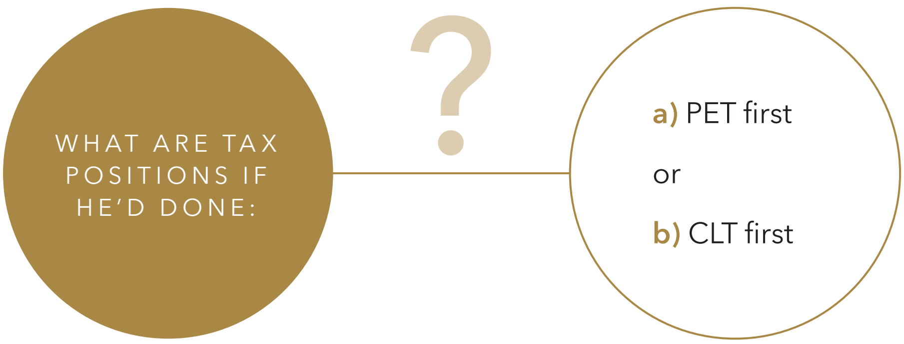
EXAMPLE 1

David makes the following gifts:
One on 10 October and one on 20 November 2018.
He has made no previous gifts.

£250,000 to his son.
This is a PET.

Transfer £300,000 into
a discretionary trust.
This is a CLT.

David then dies on 1 December 2023 and therefore dies within seven years of making the gifts. At the time of death we will assume the nil-rate band is £350,000.



IHT POSITION ON DEATH IF PET IS MADE FIRST

First calculate if any lifetime tax is due

Firstly, we must look at the CLT and ascertain if this is subject to IHT. As the PET was made first this used up the annual exemptions for 2018/19 and for the previous year. Note that here HMRC practice is to notionally allocate the annual exemption in chronological order. This means the PET is reduced by two annual exemptions of £3,000 to be £244,000. We then need to calculate if any immediate IHT was chargeable on the gift to the discretionary trust:

Immediate IHT on transfer to discretionary trust?		
Gift into trust		£300,000
Nil-rate band	£325,000	
Previous CLTs in last seven years	(£0)	(*NB the PET is not included here as at this point it has not failed)
Nil-rate band available	£325,000	(£325,000)
Chargeable Transfer		(£0)

Here there was no tax paid on the establishment of the CLT. Note, if there was some IHT to pay this could increase the transfer if the tax was paid by the settlor so it is important to establish this first.

Tax on David's subsequent death within seven years of making the gifts

Now we look at the death estate and the tax on the failed PET and CLT. Remember here that, under IHT principles, where a person dies any transfers of value in the previous seven years prior to death must be taken into account. We must take these failed transfers in chronological order starting, in this example, with the PET.

PET		£244,000
Nil-rate band at death	£350,000	
Previous CLTs in last seven years	(£0)	
Nil-rate band available	£350,000	(£350,000)
Tax to pay		£0

Now we work out the additional tax on the CLT bearing in mind that no IHT was paid at the time the trust was made (as above).

CLT		£300,000
Nil-rate band	£350,000	
Previous CLTs in last seven years	(£244,000)	(*NB the failed PET is now chargeable)
Nil-rate band available	£106,000	(£106,000)
Chargeable to IHT		£194,000
IHT to pay at death rate of 40%		£77,600
Less taper relief (five to six years so 60% tapering)		(£46,560)
Tax to pay on failed CLT		£31,040

IN SUMMARY

- The gift to the son was a PET that utilised the annual exemptions for 2018/19 and for the previous year and has used up £244,000 of the available nil-rate band. The gift to the discretionary trust remained at £300,000
- On death, the PET failed leaving the £106,000 of nil-rate band available for the gift to the discretionary trust of £300,000
- This resulted in tax of £31,040 on the chargeable transfer, after taper relief
- Note, the available nil-rate band to offset against the deceased's estate would also be reduced by previous chargeable transfers in the last seven years which here would include both the PET and CLT.

IHT POSITION ON DEATH IF CLT MADE FIRST

First calculate if any lifetime tax is due

Again, we must look at the chargeable transfer first and ascertain if it is subject to IHT. As the CLT was made first the annual exemptions for 2018/19 and for the previous year are available. HMRC practice is to notionally allocate these in chronological order. This means the CLT is reduced by two annual exemptions of £3,000 to be £294,000. As before, we then need to calculate if any immediate IHT was chargeable on the gift to the discretionary trust:

Immediate IHT on transfer to discretionary trust?		
Chargeable transfer		£294,000
Nil-rate band	£325,000	
Previous CLTs in last seven years	(£0)	(*NB the PET is not included here)
Nil-rate band available	£325,000	(£325,000)
Immediate tax to pay		£0

Here there is no tax on the establishment of the CLT, as per the previous order.

Tax on David's subsequent death within seven years of making the gifts

Now we look at the deceased's estate and the IHT payable on the failed CLT and PET. Again, we must take these in chronological order starting with the CLT.

CLT		£294,000
Nil-rate band	£350,000	
Previous CLTs in last seven years	(£0)	
Nil-rate band available	£350,000	(£350,000)
Chargeable to IHT		£0

Again, now we need to work out the additional IHT (if any) on the PET.

PET		£250,000
Nil-rate band	£350,000	
Previous CLTs in last seven years	(£294,000)	
Nil-rate band available	£56,000	(£56,000)
Chargeable to IHT		£194,000
IHT to pay at death rate of 40%		£77,600
Less taper relief (5-6 years so 60% tapering)		(£46,560)
Tax to pay on failed CLT		£31,040

IN SUMMARY

- The gift to the discretionary trust was a CLT that utilised the annual exemption for 2018/19 and the previous year and has used up £294,000 of the available nil-rate band. The gift to the son (PET) was for the full amount of £250,000
- On death, this left £56,000 of the nil-rate band available for the gift to the bond (PET) of £250,000 which is now chargeable as David died within seven years of making the transfer
- The actual tax liability on the failed transfers in the deceased's estate in this example is the same
- Again, the available nil-rate band to offset against the deceased's estate would also be reduced by the previous chargeable transfers i.e. the failed CLT and PET.

Here, the tax liability on death is the same but this may not always be the case. As the annual exemption can reduce the chargeable transfer, this may reduce any lifetime tax that is payable i.e. if the chargeable transfer was immediately subject to IHT.

For example, assume the CLT was £500,000 instead of £300,000. If David makes the CLT before the PET, he can use the annual exemption to reduce the immediate charge to tax. However, if he makes the CLT after the PET, then the PET will notionally use the annual exemption and so the immediate charge to tax will be greater. The impact could be that David wastes the annual exemption if he survives the full seven years to take the transfers out of charge. For this reason, the CLT should usually be made first.

The order of gifts can therefore be important if there is any lifetime tax to pay, but often the calculation will result in the same IHT being paid out on death, as shown in this example. However, we also need to consider how the order will impact the periodic charge and here, the order is also important.

Let's look at the positions at the time of a periodic charge depending on whether the PET or the CLT is made first.

THE 10 YEAR PERIODIC CHARGE

PET MADE FIRST AND DEATH OCCURS WITHIN SEVEN YEARS

We will assume trust property is valued at £450,000 at the 10th anniversary and there have been no distributions of capital in the first 10 years. Here, the failed PET (£244,000) made in the seven years preceding the creation of this settlement impact upon the calculation. For the purposes of the calculations, we will assume the nil-rate band in 2028/29 is £396,000.

Value of trust at date of periodic charge		£450,000	
Nil-rate band at date of periodic charge	£396,000		
Previous chargeable transfers in last seven years	(£244,000)		(failed PET)
Available nil-rate band	£152,000		
		(£152,000)	
		£298,000	
Tax on trust at lifetime rate of 20%		£59,600	
Effective rate £59,600/£450,000 x 100%		13.244%	
Periodic charge is then 30% of Effective rate		3.973%	
IHT payable is value of property x Effective rate of tax		£17,880	

THE 10 YEAR PERIODIC CHARGE

CLT MADE FIRST AND DEATH OCCURS WITHIN SEVEN YEARS

We will assume the same assumptions, but here with no chargeable transfers having been made in the seven years prior to the creation of the settlement.

Value of trust at date of periodic charge		£450,000
Nil-rate band at periodic charge	£396,000	
Previous chargeable transfers in last seven years	(£0)	
Available nil-rate band	£396,000	
		(£396,000)
		£54,000
Tax on trust at lifetime rate of 20%		£10,800
Effective rate £10,800/£450,000 x 100%		2.400%
Periodic charge is then 30% of Effective rate		0.720%
IHT payable is value of property x Effective rate of tax		£3,240

The order of gifts has made a substantial difference to the IHT paid at the time of the periodic charge. This is because the failed PET reduces the available nil-rate band for the purposes of the periodic charge calculations. It is important to understand that this will apply for ALL subsequent periodic charge calculations i.e. not just the first 10 year anniversary.

IN SUMMARY

› If the PET is made first and the settlor survives the PET by seven years, but not the CLT, the PET would then fall out of account. This would then not impact the 10 year anniversary charges

› If the PET is made first and the settlor dies within seven years of that PET, the subsequent CLT will include the value of the failed PET for each and every periodic charge calculation

› Where a CLT is made which is then followed within seven years by a PET, this can increase the charge to tax on the failed PET. This is because, if death occurs within seven years of the PET, the previous CLT will reduce the amount of nil-rate band that can be used in the calculation of the tax on the 'failed' PET. This is despite the fact that the settlor survived the CLT by seven years. This is often referred to as the '14 year trap', which is covered later in this briefing.

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CUMULATION

One final point to note on the basic structure of IHT on death and lifetime transfers is regarding 'cumulation'. Although every individual has a nil-rate band, for the purposes of IHT, the calculations made are on an ongoing cumulative basis. The nil-rate band is therefore not a one-off allowance, but is instead used to reduce transfers of value over a 'rolling' seven year period. Here the effect is that the earliest chargeable transfer in this period gets allocated to the available nil-rate band first.

Therefore, individuals need to keep a cumulative account of any lifetime transfers they make and, for each chargeable transfer that is made (whether during lifetime or on death), it will be necessary to look back over the previous seven years to see if the nil-rate band has been 'used' during that time by earlier chargeable transfers.

In practice, the position can be quite complex because some transfers of value are immediately chargeable (CLTs) while others are simply potentially chargeable only on death (PETs). The effect of death on CLTs and PETs can lead to reallocation of the nil-rate band, as example 2 below shows:

EXAMPLE 2

YEAR 1	Mark makes a PET after any annual exemptions of £100,000.
YEAR 2	He then makes a CLT after any annual exemptions of £300,000.
YEAR 3	Mark dies.

No immediate IHT was paid as a result of the transfer of value in year 1, as this was a PET. However, when the CLT was made in year 2, any IHT would have been calculated assuming a full nil-rate band was available i.e. there were no previous chargeable transfers in the previous seven years.

Mark's death in year 3 however, means that the PET will now become chargeable and will use up some of the available nil-rate band. On death, the IHT on the CLT will now need to be recalculated.

DISCOUNTED GIFT TRUSTS (DGTS)

In response to the changes to the IHT treatment of trusts in March 2006, most providers developed two versions of DGT; one using an absolute trust and one using a discretionary trust.

The absolute trust version, whilst inflexible in terms of the beneficiaries, remains within the PET regime whereas transfers to the discretionary version are always chargeable lifetime transfers (CLTs). On the basis a discount is provided, the amount of the resulting discounted gift is the relevant lifetime transfer of value when determining the value of the CLT or PET. Again, if this is the only gift, the annual exemption can be also used to reduce an immediate charge to tax – although care should be taken here as the initial value (for calculating exit charges in the first 10 years where applicable or where related settlements are made) will still be the 'gross' amount transferred into trust.

There are circumstances, particularly where the amount the client wants to gift into trust is substantial, where a combination of the two versions may be appropriate. The discretionary trust version could be used such that the discounted gift (the CLT) is for an amount equal to the settlor's available nil-rate band with an absolute version being used for the balance of the investment.

For the reasons outlined earlier, it would normally be prudent to establish the discretionary trust version (the CLT) at least one day before the absolute version (the PET).

A FURTHER PLANNING POINT

The order of gifting may also be important if the client wishes to establish a discretionary loan trust as well as a discretionary DGT at around the same time. In these circumstances it would be preferable to effect the loan trust first because of the way the 10 year anniversary charge is calculated.

If the DGT is made first, followed by the loan trust, the available nil-rate band used in the calculations at the 10 year anniversary will be reduced by the previous discounted gift (transfer of value).

The result will be that the periodic charge could be increased due to the impact of the cumulation and the loss of nil-rate band. Conversely, if the loan trust is made first, then assuming there are no previous chargeable transfers to consider, the full nil-rate band will still be available. This is because the loan trust is established by way of a loan repayable on demand rather than a significant gift (transfer of value).

THE 14 YEAR TRAP

Where multiple transfers of value have been made over time, this can impact the available nil-rate band and thus the IHT paid on each transfer.

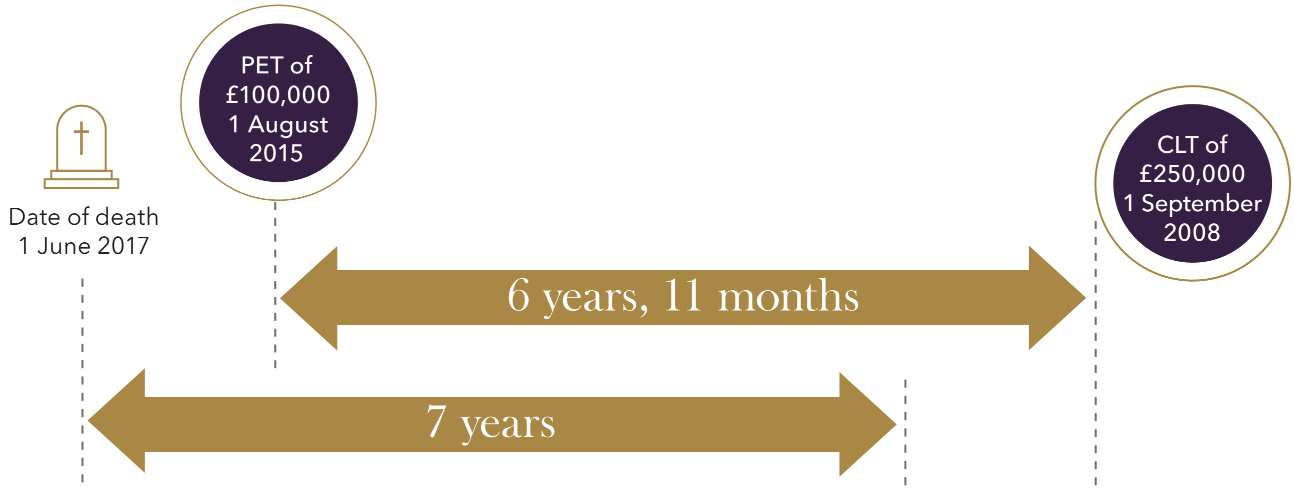
The calculation can require information from as far back as 14 years prior to death. This point often causes confusion and can be best illustrated with an example.

EXAMPLE 3

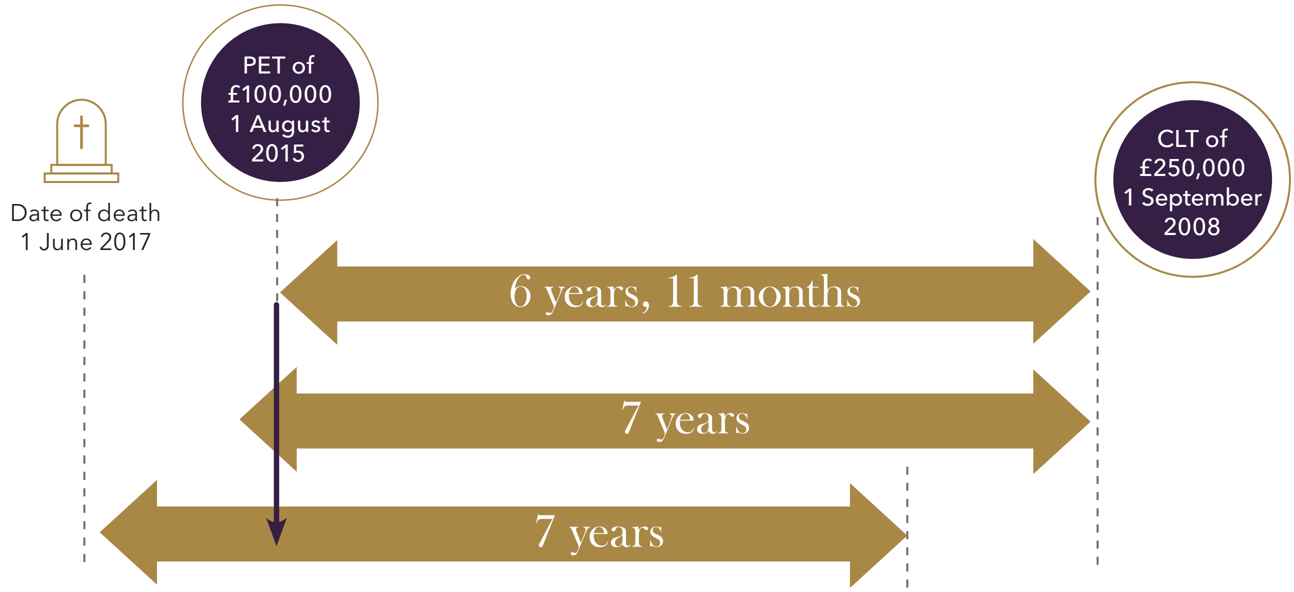
Rachael made a PET (after any available annual exemptions) of £100,000 on 1 August 2015. She previously made a CLT of £250,000 (after any available annual exemptions) on 1 September 2008. We will assume there was no lifetime tax to pay on the CLT as she had not made any prior chargeable transfers.

Rachael died on 1 June 2017 leaving an estate valued at £325,000.

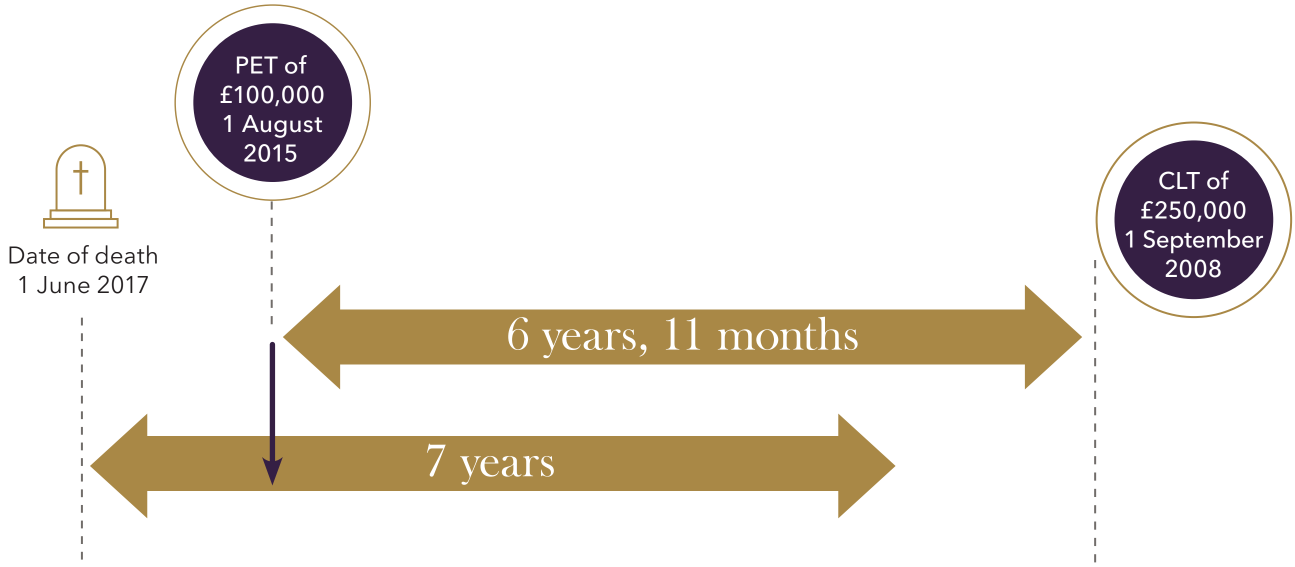
SO, WHAT IS THE IHT LIABILITY?



When calculating the available nil-rate band on death, any tax on the failed PET must also take into account the CLT made in the seven years prior to the PET.



The previous CLT of £250,000 reduced the nil-rate band that is available against the failed PET to £75,000 (£325,000 - £250,000 = £75,000)



Amount of PET liable to IHT = £25,000 (£100,000 - £75,000)
IHT liability for recipient of PET = **£10,000** (£25,000 x 40%)

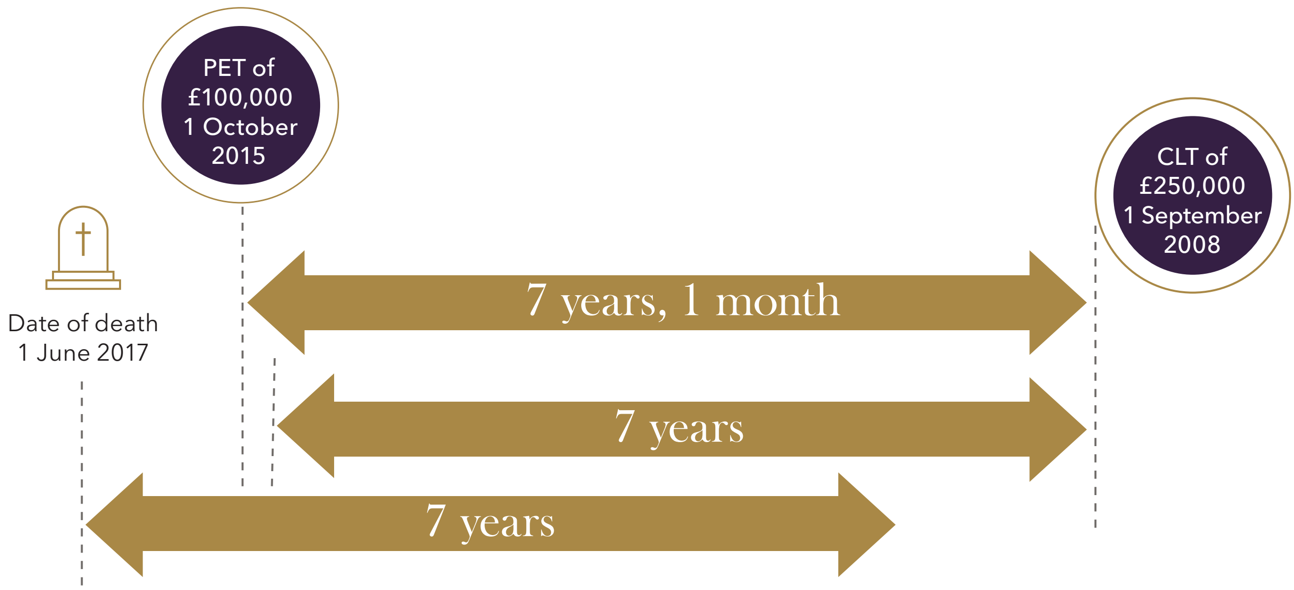
If we turn to the deceased's estate, we can now assess how much IHT is payable. Here, we apply the same principles, but we only look back seven years from the date of death itself. In other words, the 14 year trap only impacts the IHT payable on the failed PET, it does not impact the IHT payable on the death estate itself.

Here, the available nil-rate band will only be reduced in respect to the value of the failed PET itself.

ESTATE	£325,000
LESS BALANCE OF NIL-RATE BAND	(£225,000)
TAXABLE ESTATE	£100,000
IHT AT 40%	£40,000

Now, assume Rachael made a PET of £100,000 on 1 October (two months later than before) having previously made a CLT of £250,000 on 1 September 2008. She died on 1 June 2017 leaving an estate valued at £325,000.

WHAT IF RACHAEL HAD MADE THE PET TWO MONTHS LATER?



Here, the CLT now falls out of account as it was made more than seven years before the PET. The PET will still be chargeable on death and the IHT on the estate will still be £40,000. The delay in making the gift has resulted in an IHT saving of £10,000, as the CLT now falls out of account.

ORDER OF GIFTS AND 14 YEAR TRAP

The examples in this briefing have shown that, where PETs and CLTs are being considered at broadly the same time, the order of gifts is important. We concluded here the CLT should be made first to:

› utilise any annual exemption to reduce any immediate IHT (if applicable)

› avoid issues with cumulation at the 10 year anniversary.

The 14 year trap would still be relevant here, bringing the CLT into charge for a slightly longer time.

On balance this is probably an accepted risk as it broadly doesn't change the tax analysis.

However, where the gifts are made years apart, the order of gifts is very complex and there is no simple rule here. The consequences of each approach would need to be considered in relation to the impact on death on both the transfers and the taxation of the trust itself. If in doubt, where CLTs are being considered (broadly gifts to discretionary trusts) then one simple rule is to check that there have been no gifts in the last seven years and that the settlor intends to make no further gifts in the next seven years.

CONCLUSION

With regard to the order of making transfers and gifts at around the same date, the following is a basic guide:

› Settle discretionary loan trust(s) first as there should be no transfer of value

› Settle any other chargeable transfers in order of size – smallest to largest

› Then make potentially exempt transfers

› All settlements should be on different days to avoid related settlement issues.

Where gifts, including chargeable transfers, are being considered within seven years there is no simple rule and here the adviser will need to consider the impact of the death on the calculations. If in doubt, always leave seven years either side of any chargeable transfer to avoid any of the rules causing issues for your clients.

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