TECHNICAL SALES BRIEFING

IHT "BITESIZE" SERIES - PART TWO
LIFETIME TRANSFERS OF VALUE AND TAPER RELIEF

KEY POINTS

This Technical Sales Briefing:

› is the second in a series covering many aspects of UK Inheritance Tax (IHT)

› deals with lifetime transfers of value, taper relief and considerations around life cover.

LIFETIME TRANSFERS OF VALUE

Lifetime transfers of value can fall into one of three categories:

› Exempt transfers

› Potentially exempt transfers (PETs)

› Chargeable Lifetime Transfers (CLTs)

EXEMPT TRANSFERS

An exempt transfer is the most efficient transfer for IHT purposes as the asset is immediately excluded from the estate of the transferor.

Transfers between spouses – s18 IHTA 1984
Outright transfers between husband and wife are completely exempt whether made during lifetime or on death, provided the transferee is domiciled in the UK. This exemption also applies to same-sex couples registered under the Civil Partnerships Act 2004, from 5 December 2005.

This is a useful exemption as it enables UK-domiciled married couples/registered civil partners to move assets from one to the other free of IHT. It also enables them to make maximum use of both spouses'/registered civil partners' income tax personal allowances and starting and basic rates of tax where appropriate, and capital gains tax exemptions.

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Transfers between spouses where the recipient is non-UK domiciled
Prior to 6 April 2013, if the transferee spouse/registered civil partner was not UK domiciled only transfers up to a total of £55,000 were exempt. However, from 6 April 2013, the exempt amount for transfers from a UK domiciled spouse to a non-UK domiciled spouse increased substantially to £325,000. This means that, potentially, an amount of up to £650,000 can now be transferred on death to a non-UK domiciled spouse or civil partner without any liability to IHT.

Also from 6 April 2013, it is possible for a non-UK domiciled spouse/registered civil partner to make an election to be treated as UK domiciled for IHT purposes, provided either of the two following conditions are met:

A) At any time after 6 April 2013 and during the seven years ending with the date on which the election is made, the person had a spouse or civil partner who was domiciled in the UK; or

B) If a person dies after 6 April 2013 and within the period of seven years prior to their death the deceased was domiciled in the UK and the spouse, by making the election, would be domiciled in the UK.

If such an election is made, as provided for under s267ZA IHTA 1984, then the normal spouse exemption will apply in full to all transfers made to the previously non-UK domiciled spouse. If made after the death of a UK-domiciled spouse or civil partner the election must be made within two years of death. Any election must be made in writing to HMRC and, where the election is made on death, can be made by the personal representatives of the non-domiciled spouse/civil partner.

The election must specify when this is to take effect from as prescribed in s267ZB IHTA 1984. Here the election can be back-dated seven years prior to the election itself being made or the date of death, providing this date falls on or after 6 April 2013. This can be useful if the surviving spouse has received a gift from their spouse before their death. Here any election by their executors will mean the transfer is treated as an exempt transfer rather than a failed PET.

Once the election is made it is irrevocable and the UK-domiciled spouse will then be subject to IHT on their worldwide assets. However, in the case of an election made by a non-domiciled individual during their lifetime such an election will cease to apply if the person is not resident in the UK for income tax purposes for four consecutive tax years following the tax year of the election – s267ZB(10) IHTA 1984.

Such an election will usually be particularly useful on death, for example where a UK-domiciled spouse is leaving assets on death to a non-domiciled spouse. This can also be very useful if that non-domicile is then leaving the UK permanently.

£3,000 annual exemption – s19 IHTA 1984
Transfers up to a total of £3,000 in any tax year are exempt. Any part of the exemption not used in one tax year can be carried forward to the next tax year. A husband and wife/registered civil partner each have this exemption.

The annual exemption for the current year is always utilised before considering the previous year's exemption. It is also important to understand that HMRC practice is to apply the annual exemption to gifts in the chronological order in which they are made. This means that where a PET is made before a CLT this can have an impact on the lifetime tax paid on the subsequent CLT. Where gifts are made on the same day the annual exemption is apportioned between the gifts. On death the annual exemption will usually remain as allocated, but where a gift was previously exempt but isn't on death (such as where the gift received business property relief which has subsequently been removed) the annual exemption can be re-applied which is considered in Example 2.

EXAMPLE 1 – ELECTION TO BE TREATED AS UK DOMICILED

Barry and Simon are civil partners. Barry has a UK domicile but Simon is non-domiciled. They live in London but have never owned their own home. Barry dies on 1 May 2021 and leaves all his worldwide assets to Simon which are valued at £825,000. Barry has made no previous lifetime transfers prior to his death and we will assume none of the property on death is excluded property. Following Barry's death Simon decides to move back to Cuba where he was born.

Barry's death estate is ordinarily calculated as follows:

Assets passing to Simon	£825,000
Nil Rate Band	(£325,000)
Limited Spouse Exemption	(£325,000)
Amount chargeable to IHT	£175,000 x 40% = £70,000

As Simon intends to become non-UK resident for income tax purposes, an election for him to be treated as UK domiciled for IHT purposes could be considered here depending on any other planning he intends to do. Providing Simon makes the election within two years of Barry's death this could reduce any exposure to IHT. Further, as Simon is moving abroad his domicile status will only apply to him for the next four tax years after which he will then be non-domiciled.

EXAMPLE 2 – USE OF ANNUAL EXEMPTION

Larry makes the following transfers and has made no previous transfers of value:

› Gift to his son of £100,000 on 7th April 2021

› Gift to a discretionary trust of £331,000 on 1 May 2021

The gift to his son in April 2021 can be reduced by the annual exemption (AE) of £3,000 (for 2021/22) and the previous tax year, £6,000 in total. This reduces the £100,000 gift making the notional value of the PET £94,000. The gift to the discretionary trust of £331,000 is not able to utilise the annual exemption for 2021/22 or the previous year and will become liable to IHT as explained on page 2. Had Larry changed the order of the gifts here, the AE could have been utilised against the chargeable transfer, reducing it to £325,000, which would have eliminated his immediate liability to IHT on the transfer.

EXAMPLE 3 – ALLOCATION OF THE ANNUAL EXEMPTION

Assume Larry made the following transfers and has made no previous transfers of value:

› Gift to his son on 10 April 2021 of 100% share in Larry Wines – a sole trader business valued at £1,000,000

› Gift to his daughter on 1 May 2021 for £100,000

The gift to his son is an exempt transfer as it qualifies for 100% Business Property Relief. The gift to his daughter could be reduced by annual exemptions for the tax year 2021/22 and the previous year. This would make the PET £94,000 at the time the gift was made. However, should his son sell his interest in Larry Wines and not replace this with relevant business property within the relevant timeframe, this transfer becomes chargeable in the event of Larry's death within seven years. If the gift of shares becomes chargeable, HMRC practice here is to apply the AE to this gift as it happened before the gift to the daughter. In effect the AE was only "notionally" allocated to the PET as it was not immediately chargeable to IHT. The impact would be that the gift to the daughter would be for the full value of £100,000. Note where the AE has been used to calculate tax due on a **lifetime transfer** the application of the annual exemptions would never be disturbed.

£250 small gift exemption - s20 IHTA 1984

Outright gifts of up to £250 in a tax year may be made by a person to as many other persons as desired (with no limit). Once such gifts exceed £250 in a tax year this exemption does not apply and thus it would not be available to partially cover a gift of, say, £251. This exemption has no carry forward facility.

Normal expenditure out of income exemption – s21 IHTA 1984

Broadly speaking, there are three basic criteria in order to qualify for this exemption. A transfer must:

› be made out of income*

› be one of a series of regular transfers; and

› allow the transferor sufficient income to maintain their normal standard of living without drawing on capital

*The capital element of a purchased life annuity (purchased after 12 November 1974) and withdrawals from a single premium bond would not be regarded as 'income' for the purposes of this exemption.

Gifts in consideration of marriage or civil partnership – s22 IHTA 1984

These are exempt up to:

› £5,000 from a parent

› £2,500 from a grandparent or great-grandparent

› £2,500 from a party to the marriage / civil partnership

› £1,000 from anyone else

Unlike the small gifts exemptions, these are not a stand-alone exemption so gifts that exceed these amounts can still utilise the exemption up to the relevant limit.

Order of exemptions

The current year's annual exemption is used before considering any carried forward unused annual exemption from the previous tax year. If the carried forward annual exemption is therefore not used in the current year it is wasted.

When considering exemptions HMRC practice is to consider that the gifts out of income exemption is always applied first and the annual exemption(s) are then considered last.

EXAMPLE 4 – USE OF MULTIPLE EXEMPTIONS

Billy gives his daughter a wedding gift of £9,000 in the tax year 2021/22. Billy has made no transfers in the previous tax year. To calculate the transfer of value we can use both the gifts in consideration of marriage exemption **and** the annual exemption:

Wedding Gift	£9,000
Wedding exemption	(£5,000) from parent
Annual exemption 2021/22	(£3,000)
Annual exemption 2020/21	(£1,000)
Transfer of value	£0

Note here Billy could still allocate the remaining £2,000 (i.e. £3,000 less £1,000 already used on wedding gift) from the 2020/21 carried forward annual exemption to further gifts in 2021/22. Note the annual exemption from the current year must be used in priority to the exemption from the previous year. This means that the remaining exemption of £2,000 would be wasted if gifts were made in the next tax year.

Gifts to charities or registered clubs – s23 IHTA 1984
For this to apply the property must be actually gifted to the charity or be held on trust for charitable purposes.

Gifts to qualifying political parties on or after 15 March 1988 –s24 IHTA 1984
To qualify, at the last general election preceding the transfer of value the political party must have had either;

A) Two members in the House of Commons or

B) One member in the House of Commons and not less than 150,000 votes were given to candidates who were members of that party.

Certain gifts for national purposes– s25 IHTA 1984

Transfers for the maintenance and education of the family - s11 IHTA 1984
Dispositions by a married person or a person in a civil partnership are also exempt under s11 IHTA 1984 if to his or her spouse/registered civil partner for their maintenance, or to a child of either of them (including step children or adopted children), for the maintenance, education or training either to age 18 or later if that is when full time education or training ceases.

This section also covers 'reasonable' dispositions to dependent relatives for their 'care' or 'maintenance', such as making a gift to an elderly parent for assistance with their day to day expenses. The HMRC manual IHTM04177 provides some broad details of this exemption and you will note that this specific exemption is rather undefined.

TRANSFERS OF VALUE - POTENTIALLY EXEMPT TRANSFERS AND CHARGEABLE TRANSFERS

When a person makes a disposition its treatment will depend upon the property transferred and the recipient. We have already explored exempt transfers now we need to look at Potentially Exempt Transfers and Chargeable Lifetime Transfers.

POTENTIALLY EXEMPT TRANSFERS (PETS)

PETs were introduced on 18 March 1986 when IHT replaced Capital Transfer Tax and can be of any size. A PET is treated as an exempt transfer at the time it is made and provided the donor (the transferor) survives seven years from the date of the PET it falls out of account for IHT as far as the donor is concerned.

If the donor dies within seven years of the PET then the gift is included in the IHT calculation, the value (on the date it was made) 'cumulates' with the value of the estate at death. In other words, the failed PET takes first call on any available NRB on the donor's death and, if it exceeds the available NRB is taxable at the scale of IHT in force at the time the PET was made or the scale of tax applicable on death if this results in a lower amount of tax being payable.

A PET is a gift made by an individual after 18 March 1986 to:

› another individual, or to

› a bare or absolute trust

› a disabled person's trust

› Gifts made by an individual prior to 22 March 2006 to an accumulation and maintenance settlement or an interest in possession trust (where another individual has the right to receive trust income) were also PETs.

When a PET becomes chargeable on death the transfer is treated as occurring at the time it was actually made and the annual exemption for that tax year (including any unused annual exemption brought forward from the previous year) is applied to reduce the amount of the PET.

More information on the allocation of the annual exemption is covered on page 3.
Examples of the interaction of CLTs and PETs and the various tax computations are given under example 6.

CHARGEABLE LIFETIME TRANSFERS (CLTS)

Since 22 March 2006, transfers to most forms of trust are treated as chargeable transfers. Prior to that, the main example of a chargeable transfer was a transfer to a discretionary trust (for example, a trust without an interest in possession). Transfers involving companies are also chargeable transfers.

A CLT will give rise to a charge to IHT if the settlor's cumulative CLTs over the past seven years exceed the NRB at the time it is made. IHT will then be ordinarily charged at the lifetime rate of 20% where the trustees pay the tax (half the death rate) on the excess over the NRB and provided the donor survives a further seven years, no further IHT is payable on the transfer. The settlor is liable to report the transfer and deliver and account (where applicable).

Where IHT was paid on a CLT it is then allowed as a credit against the IHT payable on death. Taper relief will apply in the same way as for PETs and is covered on page 6. The lifetime IHT already paid can sometimes exceed the death rates due to taper relief but no refund of tax would be allowed.

Where the CLT was wholly within the NRB (and thus no IHT was payable at the time) there would usually be no IHT on this amount on death, as it would still be within the NRB. However, if a previous PET had become chargeable, this could reduce the available NRB that could be used against the transfer and thus give rise to an IHT charge.

GROSSING UP

If the settlor pays the tax on a CLT we have to consider the loss to the settlor's estate. Here the estate is reduced not only by the gift itself but also by the tax that the donor pays. The reduction in the donor's estate is found by grossing up the amount of the gift to allow for the tax which he has to pay. As the lifetime rate of tax is 20% then the loss to the estate is calculated by grossing up the tax payable by a further 20%, for example 20% x 100/80 which provides for an effective rate of 25%.

EXAMPLE 5 - GROSSING UP OF A CHARGEABLE LIFETIME TRANSFER

Charlie who is UK resident and domiciled makes a transfer to a discretionary trust of £300,000 in the tax year 2021/22 and wishes to pay the IHT himself. In the tax year 2019/20 he made a chargeable transfer of £325,000 but has made no other gifts. The tax is calculated as follows:

Gift to discretionary trust 2021/22	£300,000
Less annual exemptions 2021/22 and 2020/21	(£6,000)
Chargeable transfer	£294,000
Nil Rate Band remaining	£0 (£325,000 - CLT in 2019/20)
Taxable	£294,000
Tax payable at grossed up rate (20% x 100/80) or 25%	£73,500

The gross chargeable transfer here would be £367,500 - the chargeable transfer of £294,000 plus the tax paid by the settlor of £73,500. Note this amount of £367,500 is the one that sits 'on the clock' when considering cumulation principles.

TAPER RELIEF AND CONSIDERING LIFE COVER

A PET becomes chargeable if the donor dies within seven years of making the PET. Here any tax is payable primarily by the recipient of the gift (the donee). Similarly, additional tax may be payable on a CLT made within seven years of death, at the difference between the death rate (40%) and the lifetime rate (20%).

Tax would be charged either at the rates in force at the date of the gift, or the rates in force on death if these rates result in a lower amount of tax being payable. It should be noted that the effect of taper relief can never result in a refund of tax.

The PET/CLT would be taxed as if it forms the first part of the deceased's estate, taking into account any other chargeable transfers made within seven years of the PET/CLT. Here the amount of **tax payable** would be tapered as follows:

YEARS BETWEEN GIFT AND DEATH	PERCENTAGE OF FULL CHARGE AT DEATH RATES	REDUCTION IN IHT CHARGE DUE
0 - 3	100%	0%
3 - 4	80%	20%
4 - 5	60%	40%
5 - 6	40%	60%
6 - 7	20%	80%

It is important to note that **taper relief is applied to the tax payable** on the PET/CLT and not the PET/CLT itself. Thus taper relief will have no effect on gifts which fall within the NRB.

EXAMPLE 6 - OPERATION OF TAPER RELIEF WITH PETS AND CLTS

John who is UK resident and domiciled makes a gift to a discretionary trust for £341,000 on 1 November 2014 and he has made no previous transfers. John is single but has a son from his previous marriage. We will assume that John wishes to pay the tax on this transfer so we must gross up the tax. The immediate charge to IHT on this transfer is calculated as follows:

Gift to trust	£341,000
Less annual exemption 2014/15 and 2013/14	(£6,000)
Chargeable lifetime transfer	£335,000
Nil Rate Band 2014/15	£325,000
Less previous chargeable transfers in last 7 years	(£0)
Nil Rate Band remaining	£325,000
Taxable	£10,000
Tax paid at grossed up rate (20% x 100/80) or 25%	£2,500
Gross chargeable transfer is therefore	£337,500

John makes a further gift to his son on 1 October 2021 of £180,000. This would be a PET so no immediate tax charge would arise. The annual exemption for 2021/22 and 2020/21 would be available to reduce the value of this gift and the PET is therefore £174,000.

John then dies on 1 November 2027 (just over 6 years after making the PET) with an estate of £500,000. John has always rented and has never owned his own house. We now need to look at how the IHT on both the death estate and PET is calculated. We will assume the Nil Rate Band in the 2027/28 tax year is £340,000. We need to start with the failed PET and then look at the estate position:

PET		£180,000
Less annual exemption 2021/22 and 2020/21		(£6,000)
Nil Rate Band 2027/28	£340,000	
Less previous (gross) chargeable transfers in last 7 years	(£337,500)	
Nil Rate Band remaining	£2,500	
		(£2,500)
Taxable		£171,500
IHT payable at the death rate of 40%		£68,600
Less taper relief of 80% (just over 6 years since PET made)		(£54,880)
IHT payable by the son on the PET is therefore		£13,720

Estate		£500,000
Nil Rate Band 2027/28	£340,000	
Less previous chargeable transfers in last 7 years*	(£174,000)	
Nil Rate Band remaining	£166,000	
		(£166,000)
Taxable		£334,000
IHT payable by PRs at 40%		£133,600

*When looking at the estate the previous failed transfer was simply the PET. Here you do not pull in the previous CLT as this has fallen out of account. This is why it is important to consider each calculation separately.

THE LIFE ASSURANCE COVER REQUIRED TO COVER A PET

It is important to remember that taper relief is applied to the tax payable on the PET and not the PET itself. This often leads to a considerable amount of confusion as to the extent of the IHT liability and the type and extent of the life assurance required to cover a PET. For example, if a PET of less than the current NRB of £325,000 for 2021/22 is made (and there have been no previous PETs or chargeable transfers) no IHT will be payable on the PET itself and there is therefore no need for a policy (but see below for the implications on the estate). Also remember here that annual exemptions may be available to reduce a gift by up to £6,000 in any tax year as explained on page 2, for example, the value of the PET that may not become chargeable is after the application of any annual exemption.

If the PET is greater than the NRB, a decreasing term assurance policy would be required. The initial sum assured under this policy being the tax liability if death occurs within three years of the PET, decreasing by 20% per year until the gift falls out of account after seven years. However, regardless of the size of the PET, it is still necessary to consider the additional IHT liability that will arise on the deceased's estate. All PETs that become chargeable will impact the calculation of the taxable estate on death to determine the amount by which the estate exceeds the NRB and thus the amount to be taxed at 40%. Example 6 on the previous page showed this in operation.

EXAMPLE 7 – USE OF LIFE ASSURANCE TO COVER A PET

The effect of taper relief and the life assurance cover required can be illustrated by the following example. Harry gives £500,000 of his £1 million estate to his son Charles which consists of cash and some quoted shares – Business Property Relief is not available. No annual exemptions are available and he has made no previous chargeable transfers.

The IHT payable on Harry's death would be as follows:

YEARS 1 - 3	TAXABLE	TAX PAYABLE	PAYABLE BY
PET	£325,000 @ nil £175,000 @ 40%	Nil £70,000	Charles
Estate	£500,000 @ 40%	£200,000	Harry's PRs
Total tax		£270,000	
YEAR 4	**TAXABLE**	**TAX PAYABLE**	**PAYABLE BY**
PET	£325,000 @ nil £175,000 @ 40% (Subject to 20% taper relief)	Nil £56,000	Charles
Estate	£500,000 @ 40%	£200,000	Harry's PRs
Total tax		£256,000	
YEARS 5 - 7			

The appropriate percentage of taper relief would then be applied to the tax on the £175,000 PET for example 40%, 60% and 80%. In other words, the tax payable on the PET continually reduces year on year due to taper relief until it falls out of account in year 8.

YEAR 8 ONWARDS	TAXABLE	TAX PAYABLE	PAYABLE BY
Estate	£325,000 @ nil £175,000 @ 40%	Nil £70,000	Estate
Total tax		£70,000	

Three life assurance policies in total would be required to cover the potential IHT liability, these being a decreasing term assurance, a level term assurance and a whole life assurance.

DECREASING TERM ASSURANCE POLICY FOR SEVEN YEARS (GIFT INTER-VIVOS)

This policy will cover the potential IHT liability on the PET of £500,000 if death occurs within seven years. The sum assured required would be £70,000 (the initial liability) for the first three years, then reducing by 20% per year from the start of the fourth year. As Charles (the donee) is liable to pay the tax on the PET, the policy could be effected on a 'life of another' basis, the donor (Harry) being the life assured and (Charles) the grantee.

Alternatively, the donor could effect a policy in trust for the donee. Whichever method is used, on the donor's death during the term, the proceeds would be payable immediately so that the tax could be paid.

WHOLE LIFE ASSURANCE

This policy should be effected for a sum assured of £70,000, being the IHT liability on the remaining estate of £500,000, as this liability will continue throughout the donor's lifetime (ignoring changes in values and tax rates). The policy should be effected in trust for the person(s) who will suffer by virtue of the IHT liability on the donor's death to ensure that the proceeds are payable outside the deceased's taxable estate.

LEVEL TERM ASSURANCE FOR SEVEN YEARS

This is the policy that is sometimes forgotten in the process of providing full cover. As the sum assured under the whole life policy is only sufficient to cover the ongoing liability once the PET has fallen out of account, it will be seen that a separate policy is necessary to cover the additional liability which would arise should death occur within seven years and the PET becomes aggregated with the remaining estate.

A seven year level term assurance policy with a sum assured of £130,000 would be appropriate with the £130,000 sum assured representing 40% of NRB that would be lost to the estate should the donor die within seven years and the PET become chargeable. A seven year term is chosen as the PET would fall out of account and become an exempt transfer after seven years.

FURTHER UPDATES IN THIS SERIES AND OUR UTECH SITE

The next Technical Sales Briefing in this series will look at gifts with reservation of benefit and pre-owned asset tax.

Note the content in this briefing is taken from our comprehensive Inheritance Tax Manual which is available in the Technical Briefings section of our uTech site (www.utmostinternational.com/wealth-solutions/our-wealth-solutions/united-kingdom/utech/). uTech has several other technical briefings exploring the more niche and complex areas of UK IHT. These include several guides to the Residence Nil Rate Band and a detailed briefing exploring Domicile, Remittance Basis and Excluded Property.

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