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INHERITANCE TAX MANUAL

The information in this manual is based on Utmost's understanding of current law and HM Revenue & Custom's practice as at 1 June 2019. Tax rules may change and depend on individual circumstances. This information does not constitute legal or tax advice and must not be taken as such. The companies in the Utmost Group can take no responsibility for any loss which may occur as a result of relying on any information in this manual.

This manual explains in detail the operation and application of current UK Inheritance Tax legislation. It should be read in conjunction with the relevant product guide and other documents, including the Guide to Domicile, Residence and Excluded Property, which are available from our website.

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BACKGROUND TO INHERITANCE TAX

Inheritance Tax (IHT) was introduced on 18 March 1986 to replace Capital Transfer Tax which had, in turn, replaced Estate Duty on 12 March 1975. The main provisions governing IHT are contained in the Inheritance Tax Act 1984 (IHTA 1984).

IHT is generally thought of as a tax payable on death but it can also be payable on certain lifetime transfers, principally transfers to discretionary trusts and, indeed, most other trusts after 22 March 2006.

However, IHT can often be mitigated through good financial planning and this is an area where advisers can add value. This manual provides many worked examples to try and better explain the operation of certain aspects. In addition, we would also encourage advisers to read HMRC's online IHT guidance:
https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual

DOMICILE AND ITS IMPORTANCE FOR DETERMINING LIABILITY TO IHT

A key factor in deciding the extent to which there is a liability to IHT is the domicile of the person making the transfer. It is of no direct consequence for IHT purposes whether a person is 'resident' in the UK for tax purposes, although a lengthy period of continual UK residence could cause them to be deemed domiciled in the UK as discussed later in this section.

- A UK domiciled person is assessable to tax on transfers of any assets wherever the assets are situated.
- A non-UK domiciled person is only assessable on transfers of assets situated in the UK.

DOMICILE

A person is domiciled in the UK if, broadly, they are deemed to consider the UK their home by virtue of their day to day actions. Factors such as having a house, working and having a family in the UK will all be taken into account in determining a person's domicile. For most IHT purposes, UK domicile covers persons:

- Domiciled in the UK under general law at any time during the three years preceding the transfer; or
- Deemed Domicile which applies where a person has been resident in the UK in not less than 15 of the 20 tax years preceding the transfer. From 2017/18 anyone who meets this criterion will be deemed UK domiciled for all tax purposes.

Since 6 April 2013, it has been possible for a non-UK domiciled spouse to make an election to be treated as being UK domiciled for IHT purposes. If such an election is made, then the normal spousal exemption will apply in full to all transfers made to the previously non-UK domiciled spouse. This is explained later in this manual.

Since 2017/18, all UK residential property held directly or indirectly by a non-UK domiciled person will also be brought into charge for IHT purposes and will not be considered excluded property. This affects all UK residential property which is owned by trustees, an offshore company or a partnership.

Domicile and indeed UK residence is a complex matter and more detailed information on this can be obtained by reading our Guide to Domicile, Residence and the Remittance basis which is available from our website **www.utmostwealth.com**

MEASURE OF CHARGE

The amount chargeable to IHT on lifetime transfers is measured by the transferor's loss to their estate and not necessarily the value passing to the transferee. No account is taken of other taxes, for example capital gains tax, or incidental expenses.

If the transferor bears the tax, IHT on a chargeable lifetime transfer (CLT) is calculated on the value transferred plus the tax which is referred to as 'grossing-up'. If the transferee bears the tax there is no grossing-up.

A person's estate comprises all the property to which they are beneficially entitled or which they can dispose of as they see fit. The estate also includes any 'gifts with reservation' made since 18 March 1986 (see the gifts with reservation section on page 28). The value of some settlements, or a part thereof, may also be added to the total.

EXAMPLE 1 – LOSS TO THE ESTATE PRINCIPLE

For transfers of value it is always the loss to the estate by the transferor which is taken into account for IHT calculations, not the value received by the transferee.

Billy owns 550 shares (a 55% holding) in ABC Ltd and he decides to give 150 (15%) of these shares to his son John. Billy's spouse Barbara does not own any shares in the company. As Billy owns a majority shareholding in ABC Ltd, the value of his shares before and after the gift will be quite different as his loss of control in ABC Ltd must be taken into account. In other words, we cannot just apportion the value of his shares actually gifted using a 55% holding and instead must look at the values of the shares in their own right before and after the gift. We will assume the following valuations for different holdings of shares in ABC Ltd:

A 55% holding is worth £137,500

A 40% holding is only worth £60,000 (not £100,000, which would be the apportioned value)

A 15% holdings is then worth £18,000

Here Billy's loss, and thus the value deemed transferred, is calculated as £137,500 - £60,000 = £77,500. This is calculated as his effective loss, which is the difference between the current value of his holding and the value after the transfer. This is considerably different to the value of the shares received by his son John which are valued at £18,000.

VALUATION AND POST MORTEM RELIEFS

VALUATION OF ASSETS FOR IHT PURPOSES

The general basis of valuation of an asset is the value it would fetch if sold on the open market and this will often be a matter for negotiation with HM Revenue & Customs. If a transfer of value (as explained later in this manual) reduces the value of assets retained by a transferor, these assets have to be valued before and after the transfer in order to determine the loss to the transferor.

RELATED PROPERTY

This occurs where the assets of a husband and wife or civil partners are worth more when taken together than if valued in isolation. For example, if there was a pair of antique vases where they each own one vase, the assets of each of them are valued as a proportion of the total value.

The way related property is valued depends on the property itself. Shares are valued in relation to the combined value, whilst chattels are apportioned using the following formula:

A / A + B * C

Where:

A - Is the value of assets held by spouse A

B – Is the value of assets held by spouse B

C – Is the combined value of the assets:

POST MORTEM RELIEFS

There are also post mortem reliefs available if, following death, certain assets drop in value. As the asset could be sold to claim a reduction and immediately repurchased there are anti-avoidance measures to counter this type of 'bed and breakfast' arrangement. The relief and restrictions on reinvestment are dependent on the type of asset and these are listed in the table below:

TYPE OF ASSET	DEADLINE FOR CLAIM	REINVESTMENT RESTRICTION
Quoted shares or securities	Within 12 months of death (IHTA '84 s179)	2 months after the last sale in the 12 month period
Land and Buildings	Within 3 years of death (IHTA '84 s191) - certain small losses are ignored if less than the lower of 5% of the probate value or £1,000.	4 months after the final sale in the 3 year period

There is also a similar provision (subject to numerous qualifications and special rules) for the lower value to be substituted for the calculation of any tax, or additional tax, arising on death within seven years of a potentially exempt transfer or a chargeable lifetime transfer where the value of property has decreased.

EXAMPLE 2 – FALL IN VALUE RELIEF

Carl is UK domiciled and has never married. He dies with a house in Southampton worth £500,000 at the date of his death and £20,000 in a UK bank account. He leaves his entire estate to his daughter Samantha. Ordinarily, Carl's estate would be liable to IHT as follows:

House	£500,000
Bank Account	£20,000
Total	£520,000
Less RNRB	(£125,000)* RNRB is used up first *Tax year 2018/19
Less NRB	(£325,000)
Amount subject to IHT	£70,000

Following Carl's death, Samantha decides that she would like to sell the house. It takes a while for the executors to sell the house and the value actually obtained is much less than the probate value of £500,000. It eventually sells two years later for a value of only £400,000; a loss of £100,000 or 20% of the original probate value. Here the executors could make a claim under s191 to substitute the sale value instead of the probate value of £500,000. As the loss is more than the amount subject to IHT, the effect is to wipe out any IHT due on the estate.

TRANSFERS OF VALUE AND EXEMPT TRANSFERS

A transfer of value is any disposal made by which the value of the transferor's estate is reduced. However a disposal is not a transfer of value and therefore not liable to IHT if it is:

› An exempt transfer, such as transfers to UK domiciled spouses or gifts to UK or EEA charities

› Shown that it was effectively a commercial transaction and not intended to confer any gratuitous benefit. For this to apply it must be made either:

- Between persons not connected with each other, or
- On terms that might be expected to be made at arm's length between persons not connected* with each other.

*Connected persons would include a spouse and other relatives, including uncles, aunts, nephews and nieces.

› Allowable in computing profits or gains for income tax or corporation tax purposes

› A contribution to a registered pension scheme

› To provide benefits on or after retirement for a person who is not connected with the provider who is or was employed by him up to approvable limits (or for that person's widow(er) or dependant(s))

› The waiver or repayment of remuneration assessable under the Income Tax (Earnings & Pensions) Act 2003 (formerly Schedule E)

› The waiver of a dividend on shares within 12 months before the right to the dividend accrues.

RATES OF IHT

From 6 April 2019 the rates are as follows:

TAXABLE ESTATE	RATE ON DEATH
0 - £325,000	NIL
Over £325,000	40%*

The band where no IHT is payable is referred to as the Nil Rate Band (NRB). The NRB threshold is £325,000 and is to remain at this level for the tax years up to and including 2020/21.

*From 6 April 2012, the rate is 36% where an individual leaves 10% or more of their baseline amount, as given in Schedule 1A(5) IHTA 1984, to charity. The 'baseline amount' is calculated as the amount charged to IHT **after** the deduction of any available NRBs and exemptions. There is no requirement here to claim the reduced rate and if the estate qualifies then it automatically applies.

Transferable Nil Rate Bands (TRNB) - from 9 October 2007, any proportion of unused NRB on the first death of a spouse/civil partner can be transferred to the survivor's estate on his/her subsequent death.

Chargeable lifetime transfers - (discretionary trusts, and most other trusts after 22 March 2006) are taxed at half the death rate, currently 20%. Such a charge will arise where the settlor's cumulative total of chargeable transfers in the previous seven years exceeds the NRB.

EXAMPLE 3 – USE OF CHARITABLE GIFTS ON DEATH

Sally, who was UK domiciled, died in 2016 leaving her entire estate to her husband Bob. Bob subsequently died in October 2019 with an estate valued at £700,000 on his death. Sally and Bob never owned their own home, and thus no Residence Nil Rate Band (RNRB) is available (see page 22 for further explanation of RNRB). In his will Bob leaves his entire estate to his son Charles and £4,000 to charity. As Sally did not use her NRB on death, the NRB available on Bob's death is uplifted by a full 100%. This gives Bob's estate an available NRB of £650,000. We can therefore work out the IHT due on Bob's estate.

First, let's consider the 'baseline amount':

Estate value	£700,000
Less NRB x2	(£650,000) 2019/20*
'Baseline amount'	£50,000

*The NRB of £325,000 is uplifted by 100%

Now calculate the IHT chargeable on the estate:

Estate value	£700,000
Less charitable gift	(£4,000) (less than 10% of the baseline amount)
Less NRB x2	(£650,000) 2019/20*
IHT due	£46,000 x 40% = £18,400
Amount received by Charles	£677,600
Amount received by charity	£4,000

*The NRB of £325,000 is uplifted by 100%

Suppose instead Bob had altered his will to leave £5,000 to charity, his estate would then qualify for the reduced rate of tax, £5,000 being 10% of the baseline amount. This would reduce the IHT payable on the estate to 36%. As the gift to charity is an exempt transfer, the position following this gift would be as below:

Estate value	£700,000
Gift to charity	(£5,000)
Less NRB x2	(£650,000) 2018/19*
Taxable estate	£45,000
IHT due	£45,000 x 36% = £16,200
Amount received by Charles	£678,800
Amount received by charity	£5,000

*The NRB of £325,000 is uplifted by 100%

The effect here is that Charles receives more money and the charity also receives a larger donation of £5,000. The only loser here is HMRC who receives less IHT as a result of the charitable gift. This type of planning can be effected by putting a clause in the will to make sure the relevant amount is left to charity and, as shown above, can be quite effective in IHT planning.

Note that where no charitable gifting was originally included in the will, such a clause will not usually provide any additional benefit to the beneficiary(ies). This is because the inclusion of a substantial charitable gift will significantly reduce the amount received by the beneficiary, despite the rate of IHT being reduced to 36%. However, where charitable gifting in the will is just below the baseline threshold of 10%, it is advisable to check to see whether amending the will could provide a greater legacy.

PAYMENT OF TAX AND INSTALMENTS

Tax on a chargeable transfer (CLT) made during a person's lifetime is payable on the date which is **the later** of either:

› Six months after the end of the month in which the transfer is made, or

› At the end of April in the following year.

This means tax on lifetime transfers from the start of the tax year until 1 October will become payable by the end of the following April and tax on transfers after 1 October up to the end of the tax year will become payable six months after the month in which they are made.

On death any tax as a result of failed transfers (CLTs and PETs) must be paid within six months of the date of death. The executors must also pay any tax on the estate within six months of death. However, the deceased's personal representatives must also pay any tax for which they are liable before they apply for probate, even if this is before the due date. In practice this may lead to positions where they cannot obtain probate simply because they have no funds to cover the IHT.

Here it may be possible for the personal representatives to draw on funds held in the deceased's bank and building society accounts for the purpose of paying any IHT that is due before the grant of probate. Alternatively, the personal representatives may need to fund the IHT from either their own pockets or by way of loan, both of which can be repaid once they obtain probate.

Tax payable on death in respect of the following qualifying property (s227(2) IHTA 84) may be paid by ten equal yearly instalments, the first being payable six months after the end of the month in which death occurs:

› the value of a business or an interest therein (including partnerships)

It should be noted that the ability to pay tax in instalments is not relevant where the assets qualify for 100% business relief. It will, however, continue to be useful in the following circumstances:

› Where there are excepted assets and where only 50% business relief is available

› Shares or securities which gave the deceased control, or together with related property would have given control of the company at the deceased's death

› Unquoted shares (including AIM listed shares) where:

- not less than 20% of the tax payable by the person accountable is in respect of those shares or other tax payable by instalments, or

- the value transferred exceeds £20,000 and the nominal value is 10% or more of the value of all the shares in the company or, if ordinary shares only, 10% or more of the value of all the ordinary shares in the company, or

› HM Revenue & Customs is satisfied that the sum cannot be paid in one sum without undue hardship

› Land of any description (including buildings) wherever situated.

The facility to pay tax by instalments extends to lifetime transfers where the transferee pays the tax and to transfers involving settled property provided that the property continues to be included in a settlement.

Interest on the whole of the tax outstanding is added to each instalment for both transfers on death and lifetime transfers. However, where tax is payable by instalments in respect of business assets, land and buildings eligible for agricultural relief, interest will be payable from the due-date of the instalment in respect of only that instalment which has become due but not paid. Note land and buildings are not necessarily business assets if they are not owned by a controlling shareholder and used by the business.

Payment by instalment will only apply to potentially exempt transfers which become chargeable if the donee has retained the qualifying property until the donor's death (or, if earlier, his own death).

LIFETIME TRANSFERS OF VALUE

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

› Exempt transfers

› Potentially exempt transfers (PETs)

› Chargeable 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.

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 an amount of up to £650,000 can now be transferred 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 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 5.

EXAMPLE 4 – 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 2019 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 5 – 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 2019
- Gift to a discretionary trust of £331,000 on 1 May 2019

The gift to his son in April 2019 can be reduced by the annual exemption (AE) of £3,000 (for 2019/20) 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 2019/20 or the previous year and will become liable to IHT as explained under the chargeable transfer section. Had Larry changed the order of the gifts here, the AE could have been utilised against the chargeable transfer which would have eliminated his immediate liability to IHT on the transfer.

EXAMPLE 6 – 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 2019 of 100% share in Larry Wines – a sole trader business valued at £1,000,000
- Gift to his daughter on 1 May 2019 for £100,000

The gift to his son is an exempt transfer as it qualifies for 100% Business Property Relief (refer to page 19). The gift to his daughter could be reduced by annual exemptions for the tax year 2019/20 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.

EXAMPLE 7 – USE OF MULTIPLE EXEMPTIONS

Billy gives his daughter a wedding gift of £9,000 in the tax year 2019/20. 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 2019/20	(£3,000)
Annual exemption 2018/19	(£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 2018/19 carried forward annual exemption to further gifts in 2019/20.

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 earlier in this manual on page 9. Examples of the interaction of chargeable lifetime transfers and PETs and the various tax computations are given under example 9.

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 donor'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. Any IHT is principally payable by the donor and not the trustees.

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 12. 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 donor pays the tax on a CLT we have to consider the loss to the donor'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 8 – 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 2019/20 and wishes to pay the IHT himself. In the tax year 2017/18 he made a chargeable transfer of £325,000 but has made no other gifts. The tax is calculated as follows:

Gift to discretionary trust 2019/20	£300,000
Less annual exemptions 2019/20 and 2018/19	(£6,000)
Chargeable transfer	£294,000
Nil Rate Band remaining	£0 (£325,000 - CLT in 2017/18)
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 9 - 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 2011 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 2011/12 and 2010/11	(£6,000)
Chargeable lifetime transfer	£335,000
Nil Rate Band 2011/12	£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 2018 of £180,000. This would be a PET so no immediate tax charge would arise. The annual exemption for 2018/19 and 2017/18 would be available to reduce the value of this gift and the PET is therefore £174,000.

John then dies on 1 November 2024 (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 2024 is £400,000. We need to start with the failed PET and then look at the estate position:

PET		£180,000
Less annual exemption 2018/19 and 2017/18		(£6,000)
Nil Rate Band 2024/25	£400,000	
Less previous (gross) chargeable transfers in last 7 years	(£337,500)	
Nil Rate Band remaining	£62,500	
		(£62,500)
Taxable		£111,500
IHT payable at the death rate of 40%		£44,600
Less taper relief of 80% (just over 6 years since PET made)		(£35,680)
IHT payable by the son on the PET is therefore		£8,920

Estate		£500,000
Nil Rate Band 2024/25	£400,000	
Less previous chargeable transfers in last 7 years*	(£174,000)	
Nil Rate Band remaining	£226,000	
		(£226,000)
Taxable		£274,000
IHT payable by PRs at 40%		£109,600

*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 2019/20 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 8, 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%. The previous examples on page 13 show this in operation.

EXAMPLE 10 – 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 – BPR 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.

GIFTS WITH RESERVATION AND PRE-OWNED ASSET TAX (POAT)

Rules were introduced in the Finance Act 1986 and apply against all gifts made by an individual on or after 18 March 1986 which are subject to a reservation of benefit to the donor. A gift with reservation is defined in legislation under s102 as one by which either:

- possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period; or
- at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise

The relevant period for this purpose is the seven years prior to death.

If a reservation exists at death the property will be considered as property to which the donor was beneficially entitled immediately before death and it will be aggregated with and form part of his taxable estate. The expression 'or virtually to the entire exclusion' is not defined in the legislation but the intention of the phrase is to prevent the gift with reservation rules from applying where the benefit enjoyed by the donor is very small.

The reservation rules only apply to the donor and not to the donor's spouse. HMRC have confirmed, however, that if a benefit is given to the donor's spouse and such benefit is shared by the donor, the original gift becomes a gift with reservation.

Specific rules apply to prevent the avoidance of the gift with reservation provisions by the conversion into or substitution of gifted property into other property. These rules provide that where the donee receives a gift of property other than a sum of money and exchanges that property for another asset of comparable value, the substituted property is to be treated as if it had been comprised in the gift.

There is also a provision under which where a gift is made into trust and that gift is a gift with reservation and the donor then makes a loan to the trustees, the property derived directly or indirectly from the loan is treated as part of the property comprised in the donor's gift into settlement.

GIFT WITH RESERVATION IHT CALCULATIONS

If at the death of a donor, it is determined that he has derived a benefit or enjoyment from the gift in the 'relevant period' (the seven years preceding death) then the property which is subject to the gift will form part of his taxable estate on death, even if he made the gift many years earlier. As there was still a gift, but the property gifted remains in the donor's estate, there are provisions to avoid a double charge to IHT arising. Here HMRC will prepare two IHT calculations:

1. HMRC will calculate the tax on the PET ignoring the gift with reservation
2. HMRC will ignore the PET and calculate the tax on the estate as if it hadn't happened

HMRC will then use the calculation which gives rise to the greater IHT charge. Often this will be the position ignoring the PET as assets often increase in value over time and annual exemptions and taper relief may be applied to the PET.

EXAMPLE 11 – GIFT WITH RESERVATION

On 1 November 2016 Sally, who is UK resident and domiciled, makes a gift of a painting to her daughter. The value of the painting was £400,000 at the date of the gift. She had made no gifts in the previous seven years and made no further gifts. However, Sally keeps the painting hanging in the study of her house and therefore the gift is not made to the exclusion, or virtually to the entire exclusion, of the donor (Sally). Sally dies on 1 December 2019 with an estate of £10,000,000 (excluding the painting now valued at £700,000) which was all left to her daughter. Sally has never married.

CALCULATION 1 (ASSUME PET MADE WHICH SUBSEQUENTLY FAILS)

Gift		£400,000
Less annual exemption 2016/17 and 2015/16		(£6,000)
PET		£394,000
Nil Rate Band 2019/20	£325,000	
Less previous (gross) chargeable transfers in last 7 years	(£0)	
Nil Rate Band remaining	£325,000	
		(£325,000)
Taxable		£69,000
IHT payable at the death rate of 40%		£27,600
Less taper relief of 20% (just over 3 years since PET made)		(£5,520)
IHT payable by the daughter on the PET is therefore		£22,080

Estate		£10,000,000
Nil Rate Band 2019/20*	£325,000	
Less previous chargeable transfers in last 7 years*	(£394,000)	
Nil Rate Band remaining	£0	
		(£0)
Taxable		£10,000,000
IHT payable by PR's at 40%		£4,000,000

CALCULATION 2 (EXCLUDE PET AND ASSUME PROPERTY WITHIN ESTATE ON DEATH)

Estate		£10,700,000
Nil Rate Band 2019/20*	£325,000	
Less previous chargeable transfers in last 7 years*	(£0)	
Nil Rate Band remaining	£325,000	
		(£325,000)
Taxable		£10,375,000
IHT payable by PR's at 40%		£4,150,000

*We can ignore Residence Nil Rate Band in both examples as the tapering provisions would apply as discussed on page 22.

Here, the IHT generated by the second calculation is greater and so would be applied. Of course, had Sally actually gifted the painting to her daughter, the first calculation would have applied and the estate would have paid less IHT as evidenced by the first calculation.

ENDING THE RESERVATION

The reservation will end if the donor no longer has enjoyment of the property gifted. If the reservation ends before death then the position is as follows:

- If the reservation ceased more than seven years before death, there is no death charge on the property in which the reservation subsisted
- If the reservation ceased less than seven years before death, the gift is taxed as if the donor had made a PET of the property at the time, on the basis of its value when the reservation ceased. However, an annual exemption cannot be applied to this PET

Again, rules exist in order to avoid a potential double charge to tax occurring which could arise where:

- There is a transfer by way of a gift of property which subsequently becomes a chargeable transfer by virtue of the donor's death within seven years and
- The property is, due to the rules relating to the release of gifts with reservation, subject to a further transfer which is chargeable as a result of the donor's death

Here two calculations will need to be performed considering the original PET and the PET made due to the release of the reservation. To avoid a double tax charge only the PET which gives rise to the **greatest charge to IHT** will be considered. This will usually be the PET caused by the release of the reservation, as assets often go up in value and this transfer of value cannot utilise the IHT annual exemptions.

EXAMPLE 12 – RELEASING THE RESERVATION

Following on from the above example, assume that instead Sally had taken the painting off her wall a year later in November 2017 and gifted it to her daughter. This would effectively release the gift with reservation as she would no longer enjoy the benefit. Let's assume at this time the painting was worth £500,000. Here the second transfer on the release of the gift with reservation would create a larger charge to IHT when Sally died on 1 December 2019 as:

a) the painting has increased in value

b) the annual exemption cannot be used on the release of a gift with reservation

c) tapering would not apply as Sally did not survive more than 3 years after the release

This is calculated as follows:

PET		£500,000
Nil Rate Band 2019/20*	£325,000	
Less previous chargeable transfers in last 7 years*	(£0)	
Nil Rate Band remaining	£325,000	
		(£325,000)
Taxable		£175,000
IHT payable by the daughter on the PET at the death rate of 40% is therefore		£70,000

N.B no A/E can be used to reduce this subsequent transfer.

It would be the £500,000 PET that would then be used in the calculations on death as the IHT raised of £70,000 is greater than the original IHT on the gift of £22,080.

The gift with reservation of benefit provisions do not apply to gifts that are exempt. The rules relating to gifts with reservation involving land were tightened with effect from 9 March 1999 in response to the House of Lords' ruling in the case of Ingram v IRC. These rules extend the existing provisions to prevent the avoidance of IHT on death by way of a lifetime gift aimed at reducing the value of the donor's estate, while leaving the donor to continue to enjoy the gifted asset as he/she did before the gift.

For gifts with reservation in relation to life assurance policies – see page 28.

PRE-OWNED ASSET TAX (POAT)

From 2005/06 provisions have applied to impose an income tax charge where an individual has the benefit of free, or low-cost, use of an asset that they previously owned. The intention is to counter schemes which avoid IHT on gifts with reservation. The provisions apply to land, chattels and gifts into settlements (trusts) of intangible assets. The charge for land will be based on the commercial rental value. The charge for chattels is calculated by applying the official rate of interest (2.5% from 6 April 2017) to the value of the asset (reduced by any payments made for its use).

The charge for intangible assets is also calculated by applying the official rate of interest to its value, reduced by any income tax or capital gains tax payable. There will be no charge if the value of the benefit is £5,000 per year or less.

Where a person is caught by the provisions of POAT they can make an election to instead be treated as having made a gift with reservation of benefit. The decision whether to make such an election will depend on circumstances including the age of the client, with elderly clients perhaps more likely to prefer an annual income tax charge than have the asset treated as being within their death estate.

BUSINESS INTERESTS

Great care should be exercised where a donor wishes to gift a partnership interest or private limited company shares and still wishes to be involved in the business and receive a salary or share of profit. Such benefits may be considered to be reserved benefits. HMRC have however indicated that provided remuneration is considered to be 'reasonable' then they would not seek to challenge under the gift with reservation provisions.

RELIEFS FROM INHERITANCE TAX

There are also various reliefs to reduce the exposure to IHT on either lifetime transfers or on the death estate.

BUSINESS PROPERTY RELIEF

Where 'relevant business property' is transferred the value transferred is reduced by the following percentages for IHT:

IF RELEVANT BUSINESS PROPERTY IS:	REDUCTION IN VALUE
A sole proprietor's business or an interest in partnership	100%
A holding of unquoted shares or shares in a company listed on the Alternative Investments Market	100%
A holding of shares giving control of a public company (i.e. over 50%) either by itself or in conjunction with the related property rules	50%
Land, buildings, machinery or plant owned by a controlling shareholder or by a partner and used wholly or mainly in the business carried on by the company or partnership	50%
Settled property used by a life tenant in his own business	50%

PROPERTY NOT ELIGIBLE FOR RELIEF

The relief does not apply to a business or company dealing wholly or mainly in securities, stocks and shares, land or buildings, or making or holding investments, or to a business carried on otherwise than for gain. The value attributable to an **excepted asset** within a business does not qualify. The main excepted assets can include:

› Property rented to third parties

› Investments, such as quoted shares, unit trusts, gilts, single premium bonds, etc

› Large cash balances which are in excess of future business requirements.

Property which is subject to a binding contract for sale will not be eligible for relief. However, when dealing with Partnership/Share Protection Assurance matters, this can often be overcome by using an agreement incorporating a double option to sell (or buy) rather than a binding 'buy and sell' agreement.

OWNERSHIP

Generally business property must have been owned by the transferor for two years before business property relief will be available.

INTERACTION WITH AGRICULTURAL PROPERTY RELIEF

Where the transferor owns agricultural property which is eligible for agricultural property relief, business property relief can only be secured in so far as the property does not qualify for agricultural property relief. Here, if an asset qualifies for both business property and agricultural property relief the agricultural property relief is considered in priority to business property relief.

BUSINESS PROPERTY RELIEF AND LIFETIME GIFTS

Where an individual makes a lifetime gift of business assets, in order for business relief to be available in respect of any tax payable on the transferor's death within seven years of the gift, the transferee must have owned the property (or similarly qualifying property replacing it) until the transferor's death or his own earlier death. Proportionate relief would be available if only a proportion of the property qualified.

AGRICULTURAL PROPERTY RELIEF

HMRC's IHT manuals and s.115 IHTA 1984 detail agricultural relief as follows:

Relief is given on 'agricultural property', such as agricultural land or pasture. It includes woodland and any building used in connection with the intensive rearing of livestock or fish if it is occupied with agricultural land or pasture and the occupation is ancillary to that of the agricultural land or pasture. It also includes such cottages, farm buildings and farm houses, together with the land occupied with them, as are of a character appropriate to the property.

It is important to understand that it is the agricultural value of the property that is considered when calculating any relief, not the value that such property may raise on the open market if used for reasons other than agricultural purposes.

The HMRC manuals also state:

The breeding and rearing of horses on a stud farm and the grazing of horses in connection with those activities are treated as 'agriculture' and any buildings used in connection with those activities are treated as farm buildings.

CONDITIONS FOR RELIEF

The relief is available where immediately before the transfer, the transferor either:

- Has occupied the property for agricultural purposes for at least the previous two years; or
- Has owned the property (whether it has been occupied by him or another) for the last seven years for the purposes of agriculture.

S130 IHTA 1984 explains that:

Where the transferor became entitled to the property on the death of another person he shall be deemed to have owned the property and, if he subsequently occupies it, to have occupied it from the date of the death. If it was inherited on the death of a spouse, any period of ownership or occupation will be taken from the date that the deceased spouse had acquired it.

The relief is applied to the value transferred before taking into account any exemptions that may be available. Agricultural property which is subject to a binding contract for sale will not be eligible for agricultural relief.

Where agricultural relief is not available business relief may become available if conditions for that relief are satisfied. The condition regarding ownership of the property by a transferee for business relief also applies for the purposes of agricultural relief.

The value transferred would be reduced by the following percentages:

MEASURE OF RELIEF	REDUCTION IN VALUE
Where the transferor has the right to vacant possession of the property or the right to obtain vacant possession within 12 months	100%
Where the transferor had a beneficial interest in the property before 10 March 1981 and agricultural relief would have been available if he had disposed of it before 10 March 1981 unless the right to vacant possession had been lost since that date by his act or omission to act	100% subject to old limits re: value of £250,000 or 1,000 acres and 50% on the excess over the said limits
Property let subject to an agricultural tenancy commencing after 31 August 1995	100%
Controlling shareholding in a farming company	100% provided that the property has been occupied by the company for two years and also the shareholders owned the shares throughout the relevant period mentioned above.

WOODLANDS

Where on death an estate includes non-agricultural land on which trees or underwood are growing then, subject to certain conditions, the person liable for the tax can elect that the value of trees or underwood is left out of account in determining the value transferred.

Tax is then charged on a subsequent lifetime disposal (other than to a spouse), with or without the land, on the proceeds of sale, or otherwise on the net value of the trees or underwood.

The tax liability falls on the person entitled (or who would be entitled) to the proceeds of sale. Tax will not be charged more than once on the same trees or underwood in respect of the same death.

Business relief may reduce the proceeds or value by 100%.

QUICK SUCCESSION RELIEF (QSR)

Where, within five years of their death, an individual's estate was increased by a chargeable transfer, credit is given against the tax payable on the individual's death for a proportion of tax charged on the earlier transfer. Note here it is important to understand who paid the tax on any chargeable transfer.

Where UK assets are passed on death it is usual that they are paid "tax free"; the actual IHT is paid from the residuary estate. However, the deceased's will can dictate that the tax is borne by the recipient (a tax bearing gift) and here the formula takes into account the tax on the transfer. Foreign assets will also be tax bearing unless the will dictates otherwise. Where CLTs are made that subsequently fail, because the donor has not survived seven years, the calculation will depend on whether the donor paid the tax. To calculate the QSR we use the formula as follows:

IHT paid on transfer x QSR% x increase in donor's estate due to transfer (net after IHT) / gross increase plus any IHT paid

The quick succession relief % applicable is then based on the time elapsed as follows:

TIME BETWEEN 1ST TRANSFER AND DEATH	QSR %
Up to 1 year	100%
1-2 years	80%
2-3 years	60%
3-4 years	40%
4-5 years	20%

After five years no quick succession relief is available. There is a similar relief where the chargeable transfer is otherwise than on death in respect of the termination of an interest in possession in a settlement.

EXAMPLE 13

Rod who is UK domiciled dies in 2018/19 leaving, as part of his wider estate, an overseas holiday home to his son Freddy which was worth £200,000. Freddy had to pay IHT on this of 40% or £80,000.

Freddy, widowed, then dies just over two years later and leaves his entire estate of £1,000,000 to his daughter. Freddy has made no previous transfers in the seven years prior to his death and on his wife's death she left her entire estate to Freddy, thus she did not use her NRB. For simplicity we will also assume Freddy has always rented and has never owned a property. The quick succession relief is calculated as follows:

Freddy's death estate	£1,000,000
Less nil rate band	(£650,000) (Freddy's NRB is uplifted for TNRB)
Chargeable estate	£350,000
IHT payable at death rate of 40%	£140,000
QSR = £80,000 x 60% x (200,000-80,000) / (200,000)	
QSR is therefore given at	(£28,800)
IHT payable	£111,200

DOUBLE TAXATION

Where double taxation agreements are in place, there is normally provision for relief from double taxation where property is subject to a similar tax abroad.

OTHER RELIEFS AND EXEMPTIONS

Transferable nil rate bands

The personal representatives of a surviving spouse/civil partner who dies on or after 9 October 2007 may claim any unused NRB that existed on the death of the first spouse/civil partner. The claim is based on the proportion of the unused NRB available on the death of the first spouse/civil partner, not the cash amount, therefore effectively 'index linking' the amount that can be transferred.

The rules also allow any unused NRB to be transferred from more than one deceased spouse/civil partner up to a limit of one additional NRB. So if someone has survived more than one spouse/civil partner, then on their death it may be possible to claim unused NRBs from more than one estate. However, the unused NRB accumulated for this purpose is limited to a maximum of the NRB in force at the relevant time (i.e. the survivor's death).

Note if the first death occurred before 12 November 1974 but after 22 March 1972, the spousal exemption was limited to £15,000, so it may not be possible to transfer 100% of the NRB on second death. Much will depend upon the amount that was transferred on first death and whether the exemption was 'unused'. Prior to 22 March 1972 there was no spousal exemption but transferable NRB may still be available depending upon the amount of estate duty used by the first spouse. For deaths on older cases it may be worth discussing the case with HMRC as this can be quite complicated.

Residence nil rate band

From 2017/18, there has been an additional residence nil rate band (RNRB) for transfers on death if the deceased's interest in a residential property which has been their main residence at some point and is included in their estate, is left to one or more direct descendants. The extra amount was £100,000 for 2017/18 and notionally at that level for previous years. It increased to £125,000 in 2018/19 and rises to £150,000 in 2019/20 and £175,000 in 2020/21. It will increase in line with the Consumer Prices Index thereafter.

Any unused RNRB will be transferable to a surviving spouse or civil partner where the second spouse or civil partner of a couple dies on or after 6 April 2017, irrespective of when the first of the couple died. This is calculated on the same basis as the NRB, based on the percentage amount unused on first death, rather than a cash amount.

The RNRB will be tapered away for estates with a value (disregarding BPR, APR or other reliefs of exemptions) of more than £2 million, by £1 for every £2 that the net value exceeds that amount.

There will also be special provisions where an individual has downsized to a smaller private residence or has ceased to own a private residence on or after 8 July 2015.

A full briefing on the RNRB can be obtained by visiting our uTech site **www.utmostwealth.com/utech**.

VOIDABLE TRANSFERS

There are provisions for tax to be reclaimed where a chargeable transfer is set aside by operation of law.

DEEDS OF VARIATION AND DISCLAIMERS

Some or all of the beneficiaries may vary the terms of the deceased's will (or the intestacy provisions) within two years of the person's death. Provided the person(s) varying their interest do not do so for a consideration in money or money's worth, the effect will be to treat the disposition as if made by the deceased. After 1 August 2002, a variation applies automatically for IHT purposes if the individual making the variation specifies that it is to have that effect and a further separate election is not necessary. It is important that when drafting the deed of variation, a statement is made in relation to s142 IHTA 84, that this section is intended to apply. Providing this statement is made, the effect, for IHT purposes, is to effectively rewrite the will as if the deceased had in fact passed their property as indicated in the deed of variation.

A disclaimer of a legacy within two years of the testator's death (other than for a consideration in money or money's worth) is not a transfer of value. There is a similar provision relating to the disclaimer of an interest in settled property.

Property that is subject to a gift with reservation (to the deceased) shall not be capable of being subject to a variation or disclaimer.

Where a trust is created by a deed of variation then, providing a statement in relation to s142 IHTA 84 is made, the trust will be considered for IHT purposes to be settled on death. However, for the purposes of income tax, the settlor will be the person who has made the variation.

PROVISION FOR FAMILY OR DEPENDANTS

Where a court order is made under the Inheritance (Provision for Family and Dependants) Act 1975 (extended by the 2014 Act), which applies to England and Wales, or under the Inheritance (Provision for Family and Dependants) (Northern Ireland) Order 1979, overriding the provisions of a will, intestacy or a disposition made within six years before death, IHT will be charged or refunded as if the order had been made by the deceased.

In Scotland there are also special rules for a person who dies after 12 November 1974 leaving a spouse and a child under 18 entitled to claim (called a legitim). If the person makes provision for the spouse but leaves insufficient to satisfy the entitlement of the legitim (roughly the right to one-third of the moveable property) IHT may be charged at death either on the basis that the claim for legitim was then satisfied or that the disposition to the spouse is not reduced.

At any time before the end of two years after reaching age 18 the child can make or renounce a claim. If he does not renounce before the end of that time he will be assumed to have made a claim. The claim, or renunciation, will be treated as having been made at the deceased's death and tax and interest will be charged, or refunded, accordingly. Where a deferred charge to tax arises as a result of a claim for legitim, tax will become chargeable on the scale of rates applicable at the date of death.

TRUSTS

INTRODUCTION

The Finance Act 2006 made major changes to the IHT rules for trusts, broadly bringing interest in possession trusts and accumulation and maintenance trusts into line with the existing regime for discretionary (or "relevant property") trusts.

The rules also apply to existing interest in possession trusts and accumulation and maintenance trusts, subject to transitional rules.

The rules mean that:

- Transfers to most trusts, including IIP trusts and accumulation and maintenance trusts are taxed as "relevant property" trusts. Most transfers made on and after 22 March 2006 are treated as CLTs, so that an immediate IHT charge of 20% is payable where the settlor's available amount of NRB is exceeded (if the settlor pays the tax, the effect of "grossing up" increases the rate to 25%)
- A periodic charge applies on all relevant property trusts of, currently, up to 6% on the value of trust assets over the NRB at each ten-year anniversary
- An exit charge proportionate to the periodic charge will also apply when capital leaves the trust between ten-year anniversaries

The rules apply to "relevant property" trusts created on and after 22 March 2006, further transfers to existing trusts, and, subject to transitional provisions, to other IHT relevant events in relation to existing trusts.

Transitional rules provided for a period of adjustment for certain existing trusts up to 6 April 2008 (extended to 6 October 2008 for interest in possession trusts), and for continuing exclusion from the "relevant property" charges if they satisfy conditions for ongoing protection.

A trust (such as a trust written subject to the Married Woman's Property Act 1882 or an express trust) for the absolute benefit of another individual is not a settlement for IHT purposes.

The "gift with reservation" provisions are particularly relevant to trusts.

RELEVANT PROPERTY TRUSTS

For relevant property trusts, IHT will be payable on the following occasions:

ON COMMENCEMENT

Transfers to "relevant property" trusts created on or after 22 March 2006 will constitute chargeable transfers.

TEN YEAR ANNIVERSARY OR PERIODIC CHARGE

At each ten year anniversary of the trust there will be a charge to IHT based on the value of the property then held in the trust. This is known as the ten year anniversary charge, periodic charge or principal charge.

The rate at which tax will be charged will be 3/10ths of the "effective rate" which is known as the "actual rate". The "effective rate" is the average rate of tax that would be charged by applying one-half of the rates on a hypothetical transfer made by an individual with a hypothetical cumulative total of transfers.

The hypothetical transfer is the aggregate of:

- The value of property then held in the trust (such as the value of the policy), but excluding the value of any "non-relevant" property, and
- The **initial value** of property in any other "related settlement" immediately after it commenced. A settlement is related if and only if it was made by the same settlor on the same day. However, changes taking effect from 6 April 2015 in respect of relevant property trusts created on or after 10 December 2014, mean that where property is added to two or more settlements on the same day, the property within the other settlements will be brought into account for the purposes of calculating the IHT charges. This measure is designed to counter avoidance by settlors using the planning strategy adopted in the Rysaffe case.

The hypothetical cumulative total of transfers is the aggregate of:

- The cumulative total of transfers, if any, made by the settlor in the seven year period before the settlement commenced (assuming there was no further addition to the trust in the period – ref s67 IHTA 84), and
- The value of any property which left the settlement in the preceding ten years

EXAMPLE 14 – BASED ON 2018/2019 RATES:

On 1 May 2018 Christopher effects a single premium whole of life policy in his sole name subject to a discretionary trust for £270,000. He has made previous chargeable transfers of £55,000 within the preceding seven years. No further (related) settlements were made on that day.

On 1 May 2028 the first ten-yearly periodic charge arises and it is necessary to value the relevant property (i.e. the policy) at that time. The policy value at this date was £425,000. To calculate the "effective rate" we need to establish:

a) The hypothetical chargeable transfer – the value of the relevant property at 1 May 2028, i.e. £425,000. (The value of any related settlement would be added if applicable); and

b) The hypothetical cumulative total of transfers, i.e. the assumed prior lifetime transfers in the seven years preceding the settlement, i.e. £55,000.

The "effective rate" of tax is calculated as follows:

Value of Property		£425,000
2028/29 Nil Rate Band* (escalated in line with RPI from 2020/21)	£450,000	
Less previous chargeable transfers	(£55,000)	
Available Nil Rate Band	£395,000	
Amount of relevant property subject to tax		(£30,000)
Lifetime IHT of 20% on assumed transfer of £30,000		£6,000
The "effective rate" of IHT is then	£6,000 / £425,000 x 100% = 1.41%	
The "actual rate" is then calculated using 30% of the effective rate = 0.423%		
Thus the IHT payable at the ten year anniversary is: £425,000 @ 0.423% = £1,800		

There are also complex provisions under s67 IHTA 84 where there are additions to the settled property which could increase the "effective rate". Under s67 where property is added to the trust, we also need to look back seven years prior to the date property was added to the trust. This is an anti-avoidance rule to counter Rysaffe-style planning with pilot trusts created with very small initial settlement values.

Where any part of the property was not comprised in the settlement throughout the ten year period immediately before the ten year anniversary the rate of tax charged on such part of the property will be reduced by 1/40th for each of the successive quarters (periods of three months) which expired before the property became comprised in the settlement.

Note: where property subsequently becomes relevant property, the trust commencement date is always taken as the date the settlement was made as defined in s60 IHTA 1984. Where property is only relevant property for a part of the ten year period then for the purposes of the ten year anniversary, a proportionate calculation is used similar to that used in the next section.

PROPERTY LEAVING SETTLEMENT

Where any property leaves a "relevant property" trust, it will be subject to a proportionate charge based on the time that has elapsed since the commencement of the trust or from the date of the last ten year anniversary if later. This is known as the exit charge.

The rate of tax chargeable before the first ten-year anniversary will be the appropriate fraction of the "effective rate". For this purpose the appropriate fraction will be 3/10ths multiplied by 1/40th for each successive quarter since the commencement of the trust (for example after 5 years = 20). Any quarter expiring before the day on which property became comprised in the trust will be ignored. The "effective rate" is the average rate that would be charged if an individual had made chargeable lifetime transfers equal to:

› The value of the property comprised in the trust or related trusts (see above) immediately after it commenced, and

› The value of the property subsequently added to the trust immediately after its addition

In many cases, particularly where the settlor had made no chargeable transfers in the seven years preceding the trust and the value of the settlor's cumulative total is within the NRB, there would be very little, if any, tax payable on property leaving the trust before the first ten year anniversary. This is because the effective rate of tax on the initial transfer will be nil.

Note here the annual exemption will reduce the transfer of value, but for the purposes of calculating exit charges in the first ten years the charge is based **on the initial value of the settlement**. This anomaly could, for example, lead to a small exit charge in the first ten years despite the transfer of value itself not giving rise to any charge to IHT.

The rate of tax chargeable between ten year anniversaries will be the appropriate fraction of the rate that was charged it was charged at the last ten year anniversary, recalculated using the NRB applicable in the year of exit if applicable.

EXAMPLE 15 – BASED ON 2019/20 RATES

Facts as for previous example, except that the life assured died on 2 May 2033, i.e. 15 years after the policy had been taken out. The policy value on death was £500,000 but there was also notional life cover of £1 per policy segment which amounted to £120. A total of £500,120 was paid to the trustees who distributed it on the date in accordance with the powers vested in them by the trust. The rate at which tax would be payable would be the appropriate fraction of the rate at which it was charged at the last ten-year anniversary, i.e.

Rate at which tax charged on previous ten-year anniversary = 0.423%

Appropriate fraction = $\frac{20}{40}$ (i.e. 5 years, or 20 quarters since last ten-year anniversary)

Therefore rate at which tax is charged = $\frac{20}{40}$ x 0.423% = 0.212%

Tax payable = £500,120 x 0.212% = £1,059.07

This assumes beneficiary pays exit charge, if the trustees pay the tax the actual rate of tax on exit is grossed up.

INTEREST IN POSSESSION TRUSTS CREATED BEFORE 22 MARCH 2006

Transfers before 22 March 2006 to a trust where there is an interest in possession (a right to the income generated by the trust fund) were treated as potentially exempt transfers. For IHT purposes, an interest in possession held under such a trust is treated in the same way as absolute ownership of the whole, or part, of the trust property in which the interest subsists.

This treatment will continue until the current interest in possession (that was in place as at 22 March 2006) comes to an end. If, when the current interest in possession comes to an end, another/other individual(s) then take(s) absolute ownership, there will be the usual consequences – a PET if the current holder of the interest in possession is alive, or a chargeable transfer on death.

If the interest in possession comes to an end after 5 October 2008 and the trustees choose to exercise their power of appointment in favour of a new beneficiary, this will be treated as the creation of a new relevant property settlement. If this happens during the lifetime of the current holder of the interest in possession, there will be a chargeable transfer.

If it follows the death of the current holder of the interest in possession, the trust fund will be in the estate of the deceased beneficiary. In either case, there could be subsequent ten-year anniversary and exit charges with the first ten year anniversary charge following death apportioned based upon the period for which the property was relevant property.

Great care is required on the part of trustees in circumstances where (a) they are considering making an appointment away from the current holder(s) of the interest in possession after 22 March 2006, or (b) in the event of the death of such beneficiary. If the trustees were contemplating a change in the beneficiaries entitled to the interest in possession they should have made such an appointment before 6 April 2008 (extended to 6 October 2008) in order to preserve the existing IHT treatment of the trust. Any appointments after that date fall within the current rules.

PROTECTED INTERESTS IN POSSESSION

Further transitional protection is available in certain limited circumstances, where an interest in possession will remain within the "old" rules even though the holder became entitled to it on or after 22 March 2006. These include:

- Immediate post-death interests; and
- Transitional serial interests

IMMEDIATE POST-DEATH INTERESTS (IPDIS)

To qualify as an IPDI, all the following conditions have to be met, in relation to the life tenant:

- The trust must be created by will, or under the intestacy rules. This requirement immediately rules out interest in possession trusts created during the settlor's lifetime
- The life tenant must have become beneficially entitled to the interest in possession on the death of the settlor or intestate person
- The interest in possession must not be a bereaved minor's or disabled person's interest

Under these provisions, a life interest for a surviving spouse/registered civil partner will normally qualify as an IPDI, and therefore attract the spouse exemption. However, if on the spouse/registered civil partner's subsequent death, the children acquire only a life interest in the trust, their interest in possession will not qualify as it does not meet the condition that the interest is acquired immediately on death.

TRANSITIONAL SERIAL INTERESTS (TSIs)

TSIs refer to interests in possession that apply to several circumstances:

1) **S49C IHTA 1984**. The interest came to an end between 22 March 2006 and 5 October 2008, and was replaced. This 'transitional regime' has now ended but would have applied where:

› The trust commenced prior to 22 March 2006

› Immediately before that date an individual had an interest in possession

› The interest in possession comes to an end between 22 March 2006 and 5 October 2008

› On that coming to an end, another individual becomes entitled to the interest in possession

› That interest is not a disabled person's or bereaved minor's interest

Under these circumstances, the pre-22 March 2006 treatment of the interest in possession will continue to apply until the termination of the subsequent interest in possession. These rules allowed for trustees to change the beneficiary entitled to the interest in possession without being penalised by the changes introduced.

Following this transitional period only two other TSIs can be created:

2) **S49D IHTA 1984** Where an individual has an interest in possession under a pre-22 March 2006 trust and, on the death of that individual after 5 October 2008, the interest in possession passes on their death to the deceased's spouse or registered civil partner. If this condition applies the spouse/registered civil partner's interest in possession would continue to be subject to the pre-22 March 2006 rules as long as the IIP lasts. Of course the passing of this IIP would also be fully exempt under the spousal exemption providing the recipient was UK domiciled.

3) **S49E IHTA 1984** Where a trust holds a policy of life assurance and a successive interest passes automatically via the trust provisions. Note this provision does not apply to capital redemption policies.

Note neither S49D or S49E IHTA 1984 apply where the trustees use their powers of appointment during lifetime. If the trustees use their powers of appointment this will not result in a TSI and this portion of the trust fund will fall into the relevant property regime.

ACCUMULATION AND MAINTENANCE TRUSTS CREATED BEFORE 22 MARCH 2006

Trustees of existing accumulation and maintenance (A&M) trusts (those in place as at 22 March 2006) had until 6 April 2008 to consider what steps, if any, they wish to take to determine the IHT treatment of the trust. They had a choice between three options:

› Appoint the trust fund absolutely to the beneficiaries on their reaching age 18. In this case, there is no change to the IHT position of the trust, which will retain its beneficial IHT treatment under the pre-2006 Budget regime

› Amend the terms of the trust to appoint the property absolutely to the beneficiaries at age 25. In this case, the trust would be referred to as an 18-25 trust and, provided certain conditions are complied with, will not suffer a ten year anniversary (or principal) charge. The main conditions are that any income has been either accumulated within the trust or applied for the beneficiary's benefit, and that no income can be applied for the benefit of any other person other than where the amounts distributed to (other) beneficiaries are under 3% of the trust fund value or £3,000, whichever is lower. An exit charge will arise when the trust fund is finally appointed to the beneficiary. The maximum rate at which IHT would be charged is therefore 4.2% (7/10ths of 6%) which would apply if the capital is distributed at age 25.

› Make no changes, leaving the trust to fall into the "relevant property" regime, with the periodic and exit charge provisions. The first periodic charge will arise on the next 10-year anniversary of the trust, which will be a part charge, apportioned to the period falling after the date the beneficiary attains age 18 (or 6 April 2008 if later). There is no charge on the trust fund entering the IHT "relevant property" regime.

It is fair to say that, in practice, many trusts will have left the original A&M provisions untouched and will have thus fallen into the relevant property regime. This point was a particularly draconian aspect of the 2006 trust changes. After all, if the original A&M trust didn't appoint the capital before, or at, age 18, the options given to amend the existing A&M trusts all required the trust to appoint benefits prior to an age the settlor originally intended.

EXCLUDED PROPERTY TRUSTS

An individual who is neither domiciled nor deemed domiciled in the UK is not liable to IHT on any assets other than UK sited assets. So an individual neither domiciled nor deemed domiciled in the UK who "settles" foreign assets outside the UK before becoming domiciled in the UK will have those assets treated as "excluded property" for the purposes of IHT.

This remains the case even if such an individual subsequently becomes UK domiciled or deemed domiciled unless the person was born in the UK. No UK IHT will arise on distributions to beneficiaries even if they are living in the UK. The settlor can be included as a beneficiary under such a trust with no adverse UK IHT consequences.

A full briefing explaining excluded property trusts and other aspects of non-resident taxation is available on our uTech site.

EXEMPTIONS AND RELIEFS

There are various exemptions for trusts related to "sponsored superannuation schemes" and to "registered pension schemes".

There are also exemptions relating to certain trusts for charities, employees, compensation funds, bereaved minors, mentally disabled persons, persons in receipt of an attendance allowance, for political parties and for protective trusts under s.33(1) Trustee Act 1925.

LIFE ASSURANCE POLICIES AND INHERITANCE TAX

POLICIES WHICH FORM PART OF THE DECEASED'S ESTATE

Policies which belonged beneficially to the deceased at the time of their death and pass to their executors or administrators as part of the estate, or policies (normally under trust) in which the deceased has reserved themself a benefit (unless effected prior to 18 March 1986 and not varied subsequently so as to increase the benefits) are taxable with the deceased's other assets, unless they are left to the surviving spouse domiciled in the UK. The value of a unit-linked contract will normally be the value of the units allocated as at the time of death or any higher amount provided by the terms of the particular contract.

POLICIES WHICH ARE THE SUBJECT OF A GIFT

Policies which are the subject of a gift after 26 March 1974 will be treated as transfers of value and may be subject to IHT depending on whether the gift is regarded as a PET or not. The value of most policies will be taken to be the greater of:

a) the total of the premiums paid under the policy, or any policy for which it was directly or indirectly substituted, or

b) the market value

With most temporary assurances the value would be the market value of the policy, normally nil.

Where the assurance is one under which the benefit secured is expressed in units (the values of which are published and subject to fluctuation) and the payment of each premium secures the allocation of a specified number of such units then, if the value of the units allocated to the assurance on the payment of the premiums is less than the aggregate of the values of those units at the time of allocation, the total of premiums paid in calculating a) (above) will be reduced by the difference.

On or after 11 April 1978 the value of a transfer on death or where the transfer does not result in the policy ceasing to be part of the transferor's estate will be the market value.

TRUST POLICIES

Policies written in trust could give rise to IHT for the reasons set out below.

GIFTS OF PREMIUMS

Where a conventional life policy is made subject to a trust, the premiums will constitute gifts by the settlor(s). It is likely that these will be covered by the settlor's £3,000 p.a. exemptions or the "normal expenditure" exemption as detailed on page 10. If the premiums are not fully exempt, the excess amounts will constitute chargeable lifetime transfers (CLTs) (to discretionary and other "relevant property" trusts) or potentially exempt transfers (PETs) (to absolute trusts).

Where the excess amounts are CLTs and are large enough, they may need to be reported. This may occur where single premium life policies are used. A return to HMRC will now only be necessary if the total of CLTs by the settlor in a tax year exceeds the nil rate band (currently £325,000), or the cumulative total of CLTs (including the one in question) in the preceding seven years exceeds the NRB.

For regular premium policies held subject to power of appointment (interest in possession) trusts created prior to 22 March 2006, the settlor should now pay the premiums directly to the life office. HMRC have confirmed that if this course of action is taken the payments to the life office would be treated, from that date, as PETs.

THE PERIODIC CHARGE AND DISCRETIONARY TRUSTS

Discretionary trusts (and other "relevant property" trusts created on or after 22 March 2006) are assessed to IHT at 10-yearly intervals, starting on the tenth anniversary of the creation of the trust. The trust will have a liability of, currently, 6% on any amount that exceeds the available NRB. In the case of joint settlors, there will be two NRBs available but it should be borne in mind that any CLTs made by each settlor in the seven years before the creation of the trust must also be taken into account.

The periodic charge would be applied to the value of the settled property, such as the policy, at the time of the charge. The basis of valuation is the open market value and this would usually be the surrender value. However, if the life assured were in serious ill-health then the value of the policy for IHT purposes may well be more than the surrender value. For non-term assurance policies, it would be necessary to take into account the premiums paid in the valuation for the purpose of the periodic charge if this is greater than the market value.

HMRC have confirmed to the Association of British Insurers (ABI) that they do not expect individuals to have medicals every 10 years for the purposes of the legislation. Provided the individual is not seriously ill to the best of their knowledge and belief, no further action would be needed.

Another area which needs to be considered is where the policy proceeds become payable shortly before the 10-year anniversary and it is not possible for the trustees to appoint the capital to beneficiaries free of trust before the periodic charge arises.

EXIT CHARGES

Exit charges can arise when property leaves the settlement, for example, when capital is appointed out of the trust to beneficiaries. The main example would be payment of the policy proceeds to the beneficiaries. The exit charge would often be nil if a payment were made within the first 10 years provided the value of the policy immediately after the trust was created, together with the cumulative total of the settlor's CLTs in the seven years prior to the creation of the trust, plus any added property, is below the NRB at the time of the exit. It is understood that if premiums under a life assurance policy in trust are paid direct to the life company they will not be added property.

The amount of an exit charge after a ten-year anniversary will depend on the effective rate of the previous periodic charge, if any (see example on page 24). If there is no periodic charge there will therefore be no exit charge in the following ten years. If there was, then the exit charge will be a fraction of the previous periodic charge based on the number of quarters that have elapsed since the last periodic charge. So, for example, 5 years (20 quarters) after a periodic charge the fraction would be 20/40ths.

GIFTS WITH RESERVATION

Where a life assurance policy is effected on or after 18 March 1986 and is made the subject of a trust, if the settlor is a potential beneficiary under the trust, the policy will be regarded as property subject to a reservation of benefit.

Life assurance policies effected prior to 18 March 1986 under which the settlor is a potential beneficiary under a power of appointment trust will not be subject to the gift with reservation provisions unless the policy is varied on or after 18 March 1986 (whether by exercise of an option or otherwise) so as to increase the benefits secured or to extend its term.

The rules applicable to variation of benefits for Life Assurance Premium Relief purposes will be relevant in this context. Should benefits be increased under the policy, the proportion of the proceeds secured by the premiums paid on or after 18 March 1986 would be deemed to form part of the settlor's estate for IHT purposes.

Where a life assurance policy is effected subject to a discretionary or a flexible power of appointment trust under which the settlor's spouse/registered civil partner is a potential beneficiary the policy will not be regarded as 'property subject to a reservation of benefit' provided there is no intention that the amounts appointed to the spouse/ registered civil partner will be used or in fact are used for the benefit of the settlor.

HMRC has confirmed that in the following examples where the settlor has retained an interest which he/she owned at the outset, a gift with reservation has not been made:

› a whole life policy effected by the life assured in trust for 'A' should 'A' survive the life assured, but otherwise for the life assured
› an endowment assurance policy effected by the life assured in trust for 'A' if living at the death of the life assured before the maturity date but otherwise for the life assured
› a whole life policy effected by the life assured in trust for 'A' if the assured should die before a specified date but otherwise for the life assured should they survive to that date or should 'A' predecease them

Further, where the settlor of a trust would benefit under the trust by operation of law, (because of a resulting trust) the trust property would not be regarded as property which is subject to a gift with reservation.

LIFE OF ANOTHER POLICIES

No IHT liability on payment of premiums would arise if the grantee paid all the premiums, since there is no element of gift involved – it is their policy. However, on the death of the grantee prior to the life/lives assured, the policy would form part of the grantee's estate and a liability would arise based on the market value of the policy.

THE EXEMPTIONS FOR PREMIUM PAYMENTS UNDER LIFE POLICIES WRITTEN IN TRUST (APART FROM SPOUSE EXEMPTION)

The normal expenditure exemption

Premium payments which fall within the terms of this exemption would be exempt from IHT. 'Normal' means habitual when it is applied to the facts of each case but HMRC has stated that this exemption will apply to the first premium in a series of payments under a policy.

HMRC has also stated that allowance for fluctuations in a person's income will be made by looking at the normal pattern of expenditure over a period of years. Thus if a person, having paid premiums out of income for a number of years, falls on hard times for one year and has to resort to capital to pay that year's premiums it would still be exempt as normal expenditure out of income.

Neither the capital element of an annuity effected after 12 November 1974 nor 'income' taken from an investment bond by withdrawals would be treated as income for the purposes of this exemption.

The £3,000 p.a. exemption

Premiums up to £3,000 p.a. would be exempt from the lifetime charge provided this exemption was not being used elsewhere.

The £250 p.a. exemption

This exemption can be used for trust policies for absolute beneficiaries, whether adult or infant, provided that the aggregate value of the outright gifts to any **one beneficiary** in any one year does not exceed £250.

*Note: availability of these exemptions is based on net premium if paid after deduction of life assurance premium relief from 6 April 1979.

The cumulative use of exemptions

It is possible to use the £3,000 exemption in addition to payments out of income which qualify as 'normal expenditure', for example, where payments are made partly out of capital or where the normal expenditure exemption is restricted. However, the £250 p.a. exemption cannot be used if other gifts are made to the same person in the same fiscal year. This exemption can also not be used in conjunction with other reliefs.

It should be borne in mind that where premium payments constitute PETs, the above exemptions only become applicable when those payments become chargeable transfers, for example where the settlor dies within seven years of the payment. Only at that time will HMRC consider a claim to an exemption.

ANNUITY/LIFE ASSURANCE COMBINATIONS

Where on or after 27 March 1974 an annuity and a life assurance policy are effected on the same life, if the assurance is vested in a person other than the person who purchased the annuity then unless it is shown that the effecting of the contracts is not an 'associated operation' the purchaser of the annuity shall be treated as making a transfer of value of the lesser of:

- the purchase price of the annuity plus the premium for the policy, or
- the value of the greatest benefit capable of being conferred by the policy at any time.

HMRC has previously stated that the contracts would not be caught by the 'associated operations' legislation if the policy had been issued on the same premium rates and medical evidence as if the annuity had not been purchased.

However, with effect from 31 December 1987 HMRC have regarded a policy as being issued on full medical evidence if it can be shown that the life assurance company has, as a minimum, obtained a private medical attendant's report and has used it as the basis of its normal underwriting procedures in the same way as it would have done had the annuity not also been purchased. HMRC can ask for the medical evidence to be produced in any particular case.

PARTNERSHIP POLICIES

If the premiums paid by the partners are roughly equated there would be no liability on the premium payments. If the arrangement between the partners is not regarded as commercial the gift with reservation provisions may apply.

PENSION SCHEMES AND INHERITANCE TAX CONSIDERATIONS

CONTRIBUTIONS, DEATH BENEFITS AND TRANSFERS

A registered pension scheme will not normally attract IHT on contributions made by either the member or their employer, or payments of death benefits paid at the discretion of the scheme trustees. It should, of course, be noted that any death benefit payment made on the member's death to a beneficiary would then form part of his or her taxable estate and would therefore increase the IHT liability on his or her subsequent death.

CONTRIBUTIONS

Contributions made by the pension scheme member for their own benefit are generally not regarded as transfers of value.

However, HMRC may argue that contributions represented a transfer of value where they were made when the member was in ill health, or unlikely to survive to take some or all of the pension benefits, and the death benefits are paid outside the member's estate (e.g. at the scheme's discretion).

HMRC guidance suggests that contributions made by the member more than two years prior to death can be assumed to have been made when the member was in good health. Therefore contributions made within two years of death are more likely to attract HMRC attention and these should be recorded on IHT schedule 409.

Large and/or unusual contributions are also likely to be viewed with some suspicion, perhaps more so than a continued direct debit payment of long established monthly contributions.

EXAMPLE 16

Connie earned £100,000 p.a. and had been paying £400 p.m. net (£500 p.m. gross or £6,000 p.a.) into her personal pension for a number of years. She was diagnosed with a terminal illness and her life expectancy was therefore considered very short.

She decided to make a significant single premium pension contribution, despite the fact she had no intention, or expectation, of drawing the pension benefits in her lifetime.

She made a contribution of £75,200 net (£94,000 gross) using her remaining pension annual allowance for the year as well as carry forward of previous unused annual allowance. This brought her contributions for the tax year up to £100,000 and 100% of pensionable earnings so the contribution benefitted in full from tax relief.

On her death a few months later her Personal Representatives should include details of the pension contribution on IHT schedule 409.

Connie had named her daughter as beneficiary of her pension fund and the scheme exercised its discretion in payment of the death benefits to her.

HMRC may well argue that the £75,200 was a chargeable transfer for IHT purposes, on the basis that her contribution was not intended for her own benefit but to reduce her taxable estate and to benefit her daughter.

THIRD PARTY PENSION CONTRIBUTIONS

HMRC guidance confirms that where third party contributions are paid:

- The payments would constitute "transfers of value" for IHT purposes
- The "transfers of value" would be the "net" payments
- The "transfers of value" could fall within the transferor's £3,000 annual exemption (if available) and/or could fall within the transferor's normal expenditure out of income exemption. This would assume that the normal three conditions are all satisfied (see page 10)
- To the extent that any of the "transfers of value" could not be covered by the transferor's exemptions, then the payments would be potentially exempt transfers (PETs).

The treatment of a third party contribution is important to consider. For example, a grandparent may have many grandchildren and may wish to make payments towards stakeholder pensions for all of them.

PAYMENT OF DEATH BENEFITS THAT FORM PART OF THE MEMBER'S DEATH ESTATE

Where the deceased member's estate has legal right to the death benefit the value of the payment should be aggregated with the rest of the member's estate.

Examples may include:

- Retirement annuity/S226 contracts & Section 32 buy-out contracts where benefits payable on death have not been assigned into trust[1]
- Some contract-based personal pensions[2]
- Where the member has a general power to dispose of death benefits (see below)
- Payments continuing after the member's death (such as guaranteed annuities).

[1]Section 32 buy-out contracts, like Retirement Annuity contracts are contracts effected between an insurance company and the policyholder/member. Death benefits are typically payable to the member's estate and are not held under trust.

[2]Not all personal pensions are written under trust but are contract based.

Where contracts are not written under trust they may be assigned into trust.

ASSIGNMENT OF DEATH BENEFITS INTO TRUST

It is common to assign pension policies that are not written under trust into trust, such that death benefits are paid at the trustees' discretion rather than to the member's estate.

The assignment of the death benefits is a transfer of value, as the death benefits that would otherwise have been paid to the estate as a right will now be paid at the discretion of the trustees. Further, in all likelihood the trust will include a range of potential beneficiaries rather than be limited to the deceased member's estate.

Provided the individual is in good health, the transfer of value made by the trust declaration would be negligible. Indeed, HMRC would not normally enquire into the individual's state of health provided that he survives the trust declaration by two years. This is because, when the member transfers the rights to death benefits into trust, it is the **present value of those death benefits** that is leaving the member's estate. If the member is in good health, and may be expected to survive to take most or all of the pension benefits in their lifetime, the present value of any residuary death benefits would negligible.

If, on the other hand, the member is not likely to survive to take most or all of the benefits in their own lifetime, the value of the death benefits would be regarded as significant (relative to the value of the fund).

So, by extension, assignment of death benefits into trust where the member is in ill health may give rise to a transfer of value that is not negligible. For this reason an assignment of death benefits within two years prior to the member's death should be reported on IHT schedule 409.

It is important to note that the assignment would be a lifetime transfer and would not aggregate with and form part of the estate at death.

The right to assign a pension is limited in that any sums which become payable on retirement (either as an annuity or as a lump sum in part commutation) must be payable direct to the member.

Many personal pension schemes are established under trust and death benefits are paid at the discretion of the scheme, as such the death benefits would ordinarily be paid free of IHT. There are, however, other circumstances where a charge to IHT may arise.

OMISSION TO EXERCISE A RIGHT (IHTA 1984 S3(3)

It was thought that HMRC held the view that a policyholder who does not exercise an option to take an annuity once they become entitled to do so (normally at age 55) makes a continuing 'omission to exercise a right' within the meaning of section 3(3) Inheritance Tax Act 1984. The result would be that, if the right was not subsequently exercised in the policyholder's lifetime, a charge to inheritance tax would arise immediately before death based on the aggregate of the lump sum which the policyholder could have taken by way of cash commutation and the open market value of the annuity which could have been obtained had the option been exercised at that time.

However, HMRC subsequently stated that they would only have considered raising a claim in such cases where there was clear evidence that the policyholder's intention in failing to take up retirement benefits was to **increase the estate of somebody else** rather than benefit him or herself.

DEATHS POST 5 APRIL 2011

IHTA 1984 s12 (2ZA) now prevents the omission of a right under IHTA 1984 s3(3) from applying to; registered pension schemes, QNUPS & s615 schemes in respect of deaths since 6 April 2011.

It is important to note however that s3(3) may still be relevant in respect of deaths that occurred pre 6 April 2011.

The Fryer and Staveley cases were both well documented and involved a claim by HMRC under s3(3).

S3(3) continues to apply to pension schemes other than those above, mainly employer-financed retirement benefit schemes (EFRBS).

THE MEMBER HAS A GENERAL POWER TO DISPOSE OF DEATH BENEFITS

Where the pension scheme member can nominate who will receive a lump sum death benefit, and where the pension scheme provider is bound to comply with that nomination, the payment falls within the member's estate. This is because the member has a general power that enables them to dispose of the property (IHTA84/s5(2) and IHTA84/s151(4)).

It is unusual for a scheme to offer such a binding nomination. Where such a binding nomination is available the scheme provider may restrict its application so that it can only be in favour of a surviving spouse/civil partner where the spouse/civil partner exemption would apply.

The terms "nomination" and "expression of wishes" have often been used interchangeably in the past and the term "nomination" is now extensively used since the introduction of the "nominees' pension" under The Taxation of Pensions Act 2014. It is important to note that only a binding nomination would be caught under s5(2) and s151(4).

Where a scheme makes a lump sum payment to the estate, but at the scheme's discretion, the lump sum is not to be regarded as part of the estate. Such a situation may arise where it is not clear to the scheme provider who a lump sum benefit should be paid to or where the situation is contentious and payment to the Personal Representatives appears to the scheme to be the best solution.

Pension death benefits may be paid as a lump sum or to provide a beneficiary's pension (dependent or nominee's pension and subsequently as a successor's pension). For the death benefits to be regarded as part of the estate at death, the member's binding nomination must apply to all benefits however they are paid. For example, where a member can make a binding nomination in respect of a lump sum death benefit, but the scheme has the discretionary power to provide a dependent/nominee's pension that is not subject to a binding nomination. Here the benefits are not regarded as part of the member's estate.

From a financial planning perspective it is important that clients understand that most schemes will not allow a binding nomination. From an IHT perspective, a non-binding nomination may be preferable but it may then come as a surprise to the member that the scheme may not necessarily pay benefits to the person they have nominated. The schemes' discretion on payment of death benefits is an important factor in preventing IHT applying to the lump sum death benefit, a compromise of control vs IHT efficiency.

PAYMENTS CONTINUING AFTER THE MEMBER'S DEATH

The deceased may have had an annuity in payment during their lifetime where the payments were guaranteed for a certain length of time. If the guaranteed payments made after the death are paid to the estate, or at the direction of the deceased, the value of those continuing payments is an asset of the estate. Conversely if the continuing payments are made at the discretion of the pension or annuity provider, their value is not treated as part of the estate.

The value of the outstanding guaranteed payments is calculated actuarially based open the open market value of the continuing payments at the date of death.

PENSION TRANSFERS

Perhaps the most topical aspect of IHT in respect of pensions is the treatment of pension transfers. The Staveley case was an important and much reported case where the IHT implications of a pension transfer were considered.

When a member transfers their pension benefits from one scheme to another, the member surrenders their rights under the first scheme in return for rights under the second.

The pension funds themselves do not fall back into the member's estate during the transfer process, however, the member does have the right to determine the terms of payment of death benefits in the receiving scheme. This right has a value because the member could* direct the payment to their own estate. If payment is not directed to their estate then there may be a loss to the estate.

*NB (it could be argued that the power to direct the future payment of death benefits is a hypothetical power where the receiving scheme refuses to accept a binding nomination from the member and the scheme rules insist on the scheme having discretion over payment of death benefits).

The value of the transfer of death benefits depends on the member's health at the time of the pension transfer. If a person is in normal health at the date of the transfer then the loss to the estate is nominal. If they are in ill-health at the date of the transfer then the loss may be significant.

Details of any transfers made within the two years before the death should be reported on IHT schedule 409.

It is important to note that the transfer would be a lifetime transfer; it is not relevant therefore where pension death benefits are ultimately paid. The spouse/civil partner exemption would not apply in respect of a lifetime transfer of value in respect of death benefits via a pension transfer.

The application of IHT to pension transfers has caused a great deal of confusion and concern not least as regards the actual valuation of the transfer of value. Some confusion relates to the misapprehension that the transfer of value is essentially the pension transfer value but, as the "loss to the estate" principle applies and the pension funds themselves do not fall back into the member's estate, this cannot be the basis of valuation.

EXAMPLE 17

Joe transfers his pension fund from Scheme A to Scheme B. The transfer value is £1,000,000 and Joe is in serious ill health when he effects the transfer.

WHAT IS THE "LOSS TO THE ESTATE" ON THE TRANSFER?

HMRC's methodology for calculating the loss to the estate is determining the difference between the "before" and "after" values:

Before value:

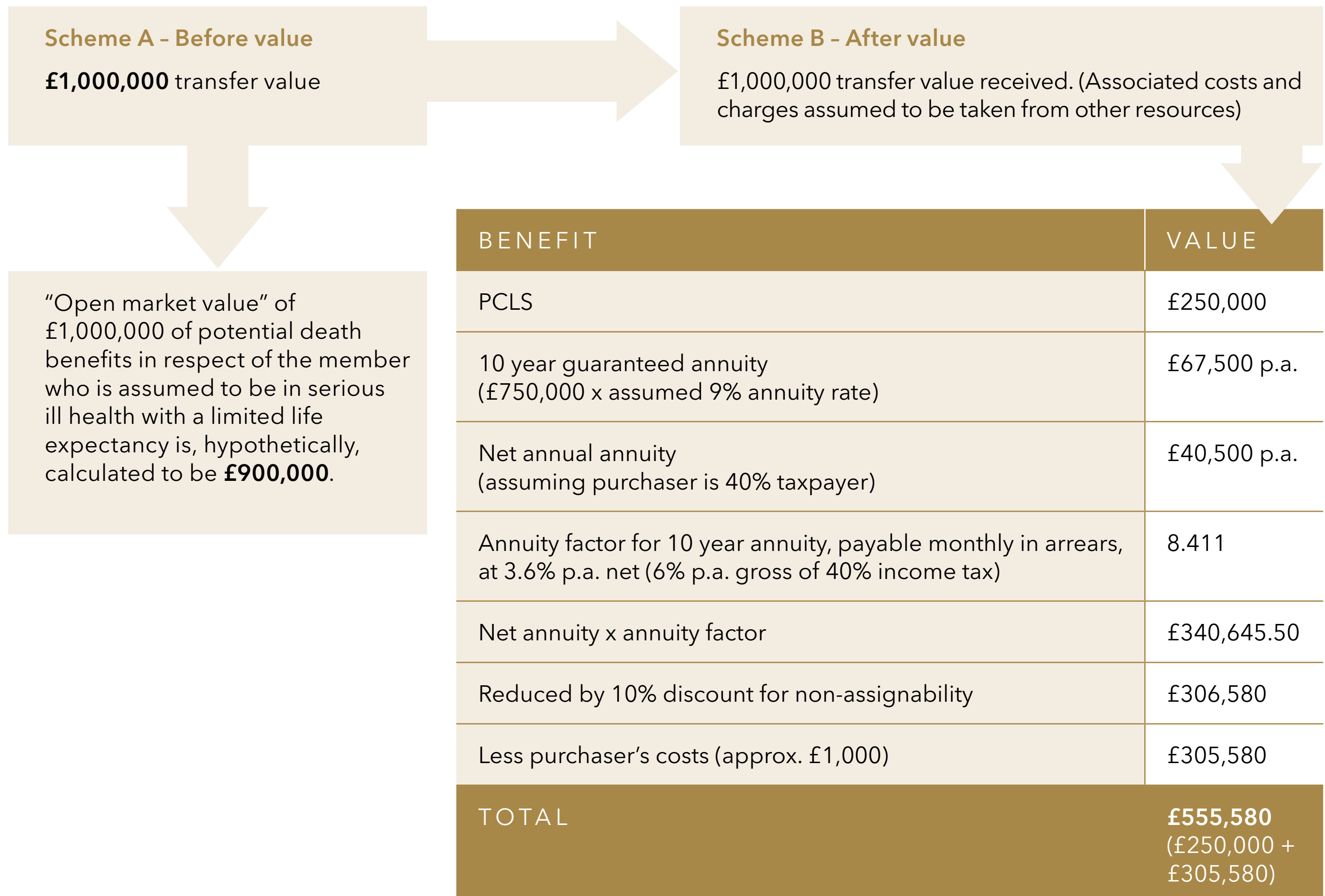
› The open market value of the death benefits that the member could have directed to be paid to their estate following the transfer

After value:

› The open market value of the pension rights available to the member after the transfer into the second scheme has been completed

If the "**after**" value is **lower** than the "**before**" value **there will be a loss to the estate** – the difference will be included in the estate for IHT purposes.

If the "**after**" value is **greater** than the "**before**" value **there will be no loss to the estate** – nothing will be included in the estate for IHT purposes as a result of the transfer.



BENEFIT	VALUE
PCLS	£250,000
10 year guaranteed annuity (£750,000 x assumed 9% annuity rate)	£67,500 p.a.
Net annual annuity (assuming purchaser is 40% taxpayer)	£40,500 p.a.
Annuity factor for 10 year annuity, payable monthly in arrears, at 3.6% p.a. net (6% p.a. gross of 40% income tax)	8.411
Net annuity x annuity factor	£340,645.50
Reduced by 10% discount for non-assignability	£306,580
Less purchaser's costs (approx. £1,000)	£305,580
TOTAL	**£555,580** (£250,000 + £305,580)

The difference between the "before" and "after" values is £900,000 - £555,580 = £344,420.

Based upon these assumptions the chargeable transfer would be **£344,420**!

What impact has The Taxation of Pensions Act 2014 and "pension flexibility" had on the above valuation method?

We understand that HMRC would expect the "after" value to be calculated based upon the options available under the receiving scheme **and** which options would generate the greater open market value. This is likely to be a combination of PCLS and withdrawal of the whole fund.

Any calculation method that would legitimately increase the "after" value would reduce the chargeable transfer.

If the member was under age 55, the "after" value would apparently depend on what benefits they had the right to receive, rather than merely a right to request (for example an ill health commutation which they might have the right to request, but no automatic right to receive).

SUMMARY

It should be assumed that HMRC would look closely at pension arrangements where the member became aware that they were suffering from a terminal illness or was in such poor health that their life was uninsurable and at or after that time the policyholder:

› Took out a new policy and assigned the death benefit on trust; or

› Assigned on trust the death benefit of an existing policy; or

› Paid further single premium contributions; or

› Increased regular premium contributions where the death benefit had been previously assigned on trust; or

› Transferred pension benefits from one scheme to another.

Even in these circumstances, where it would be difficult to argue that the actions of the policyholder were intended to make provision for their own retirement given the prospect of an early death, HMRC may be reluctant to pursue claims especially where the death benefit was paid to the policyholder's spouse /registered civil partner and/ or dependants.

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