A guide to gifts and exemptions from inheritance tax

Key takeaways:
- The difference between exempt, chargeable and potentially exempt transfers
- The inheritance tax (IHT) position in lifetime and on death
- The order of gifts and how it affects multiple lifetime transfers

Category: Estate and Trust Planning

We compare exempt, chargeable and potentially exempt tax transfers

Section 1: Inheritance tax – transfers of value

From an inheritance tax (IHT) perspective, lifetime gifts or dispositions (transfers of ownership) are transfers of value[1] and may fall into one of the following three categories:

- Exempt transfers
- Potentially exempt transfers
- Chargeable lifetime transfers.

Exempt transfers

These include (but are not limited to[2]) gifts within the £3,000 annual gift exemption, the £250 small gift exemption, gifts made regularly from income (under the normal expenditure out of income exemption) and qualifying gifts to charities and political parties.

Exempt transfers do not attract IHT either when made, or in the event of the death of the person making the transfer.

Potentially exempt transfers (PETs)

These are dispositions that result in the donor's estate being reduced and the donee's (recipient's) estate being increased. For example, gifts from an individual to; another person, a disabled person's trust or a bare trust are PETs[3]:

A PET is, as the name suggests, potentially exempt from IHT. If the donor survives the gift by seven years, the gift becomes exempt. However, should they die within seven years of making the gift, it becomes a chargeable transfer.

Chargeable lifetime transfers (CLTs)

These are immediately chargeable and may also become chargeable again on the death of the person making the transfer.

A well understood example of a CLT would be a transfer into a discretionary trust. However it is important to understand that any transfer of value that is neither exempt nor potentially exempt, will be a CLT[1].

An understanding of the available exemptions and the definition of a PET (above) is useful when trying to establish whether a client has made a CLT[1].

Lifetime transfers – charge to IHT in transferor's lifetime

Exempt and potentially exempt transfers do not attract a charge to IHT when they are made, although a PET may attract a tax charge on the transferor's death if death is within seven years of the gift.

A CLT may attract a charge to IHT when made if the chargeable transfer exceeds the available nil rate band (NRB). This charge is often referred to as an entry charge.

Where the chargeable transfer, plus the sum of chargeable transfers made by the same person within seven years prior to the CLT in question (their cumulative total[4]) exceed the prevailing NRB, a charge to IHT of 20% of the excess applies.

What about a larger CLT, above the NRB?

Case study 1

Hassan has never made any previous gifts but decides, on 31 July 2019 (2019/20 tax year) to transfer £200,000 into a discretionary trust for his grandchildren. How is this treated for IHT purposes?

Transfer	£200,000
LESS:	
Annual gift exemption 2019/20	(£3,000)
Annual gift exemption 2018/19	(£3,000)
	£194,000
PLUS:	
CLTs made by Hassan in previous seven years	£0
Total CLT	£194,000
LESS:	
NRB 2019/20	(£325,000)
Excess	£0

As there is no excess above the NRB, there is no entry charge.

Case study 2

Hassan has never made any previous gifts but decides, on 31 July 2019 (2019/20 tax year) to transfer £431,000 into a discretionary trust for his grandchildren. How is this treated for IHT purposes?

Transfer	£431,000
LESS:	
Annual gift exemption 2019/20	(£3,000)
Annual gift exemption 2018/19	(£3,000)
	£425,000
PLUS:	
CLTs made by Hassan in previous seven years	£0
Total CLT	£425,000
LESS:	
NRB 2019/20	(£325,000)
Excess	£100,000

The excess of £100,000 is subject to the lifetime rate of IHT @ 20%. Therefore, if the trustees are going to pay the tax, the tax due is £20,000. Hassan does have the option to pay the tax, but if he does, the tax payment is an additional CLT. As such, the tax liability is £25,000 or 25% of the excess.

Why 25%?

In paying the £25,000 tax liability, Hassan has now made a CLT of £450,000. The excess above the NRB is now £125,000 rather than £100,000.

£125,000 x 20% (IHT lifetime rate) = £25,000

How do previous transfers of value (the cumulative total) affect the above calculation?

Case study 3

Hassan decides, on 31 July 2019 (2019/20 tax year) to transfer £431,000 into a discretionary trust for his grandchildren.

He has made the following gifts previously:

- 20 April 2008 – £250,000 discretionary trust
- 25 December 2010 – £100,000 gift to his daughter to help her buy a house
- 10 September 2012 – £5,000 gift to his son to help buy a second-hand car
- 21 August 2013 – £100,000 gift to his son to help him buy his first house
- 20 May 2015 – £100,000 discretionary trust

In calculating the entry charge for the CLT made on 31 July 2019, we need to look back seven years to 1 August 2012.

Let's deal with these gifts in chronological order:

20 April 2008 (2008/09)

- This was a CLT of £244,000 (as we can reduce the gift by £6,000) but it is now more than seven years since Hassan made this gift.
- We can disregard this transfer.

25 December 2010 (2010/11)

- This was a PET of £94,000 (as we can reduce the gift by £6,000, 2010/11 & 2009/10 annual gift exemptions). But it is now more than seven years since Hassan made this gift, it is now an exempt transfer.
- We can disregard this transfer.

10 September 2012 (2012/13)

- This is within our seven-year time frame but is within the 2011/12 & 2012/13 combined Annual Gift Exemptions of £6,000.
- The gift is exempt. We can disregard this transfer.

21 August 2013 (2013/14)

- This gift is also within our seven-year time frame.
- It is a PET, but we can reduce the gift by the £3,000 Annual Gift Exemption for the 2013/14 tax year[5] resulting in a PET of £97,000.
- As a PET and not a CLT, we can disregard this transfer.

20 May 2015 (2015/16)

- This transfer is within our seven-year time frame and is a CLT. We can reduce the transfer by £6,000 (annual gift exemptions 2015/16 & 2014/15) resulting in a CLT of £94,000.
- As a chargeable transfer, we need to include this in the entry charge calculation for the transfer made on 31 July 2019.

Hassan's cumulative total is £94,000

Transfer	£431,000
LESS:	
Annual gift exemption 2019/20	(£3,000)
Annual gift exemption 2018/19	(£3,000)
	£425,000
PLUS:	
CLTs made by Hassan in previous seven years	£94,000
Total CLT	£519,000
LESS:	
NRB 2019/20	(£325,000)
Excess	£194,000

It is more common to do the calculation by reducing the NRB available to the estate by the cumulative total of CLTs. It is perhaps easier to re-work the above calculation as follows:

Transfer	£431,000
LESS:	
Annual gift exemption 2019/20	(£3,000)
Annual gift exemption 2018/19	(£3,000)
	£425,000
LESS:	
NRB (£325,000 – £94,000)	£231,000
Excess	£194,000

The excess of £194,000 is subject to the lifetime rate of IHT @ 20%, therefore the trustees are liable to a tax charge of £38,800.

Hassan does have the option to pay the tax, but if he does, the payment of the tax is an additional CLT. As such, the tax liability is £48,500 or 25% of the excess.

Why 25%?

In paying the £48,500 tax liability, Hassan has now made cumulative CLTs of £567,500 and the excess above the NRB is now £242,500 rather than £194,000.

£242,500 x 20% (IHT lifetime rate) = £48,500

Lifetime transfers – charge to IHT on transferor's death

IHTA 1984, s4(1) tells us that:

"On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death"

On death, lifetime gifts are "cumulated" with the estate at death and may also become chargeable to IHT. PETs and CLTs made within the seven years prior to death become chargeable on death. In fact, we may also need to consider CLTs made up to 14 years prior to the transferor's death, under "the 14-year rule".

Cumulation

A taxpayer's cumulative total is the sum of their chargeable transfers over the previous seven years. The transfers of value that make up the cumulative total will vary depending upon the event.

The cumulative total for:

Lifetime transfers

- The sum of CLTs made by the taxpayer in the previous seven years
- Disregard PETs and exempt transfers

Death

The sum of chargeable transfers made in the seven years prior to death which include:

- CLTs
- Failed PETs
- Disregard exempt transfers

Relevant property trusts periodic charges

The sum of chargeable transfers made by the settlor in the seven years prior to this settlement which include:

- CLTs
- Failed PETs
- Disregard exempt transfers

Let's look at an example of how the cumulative total affects the IHT calculation on death:

Case study 4

Hassan dies on 1 December 2019 (2019/20) leaving an estate of £500,000, including his home valued at £200,000, to his children.

He was divorced and there are no transferable NRB or RNRB available.

He has an NRB of £325,000 + RNRB of £150,000 (2019/20) = £475,000

Lifetime transfers: Hassan had made no lifetime transfers.

Estate	£500,000
LESS:	
NRB	(£325,000)
RNRB	(£150,000)
	£25,000
IHT @ 40%	**£10,000**

Case study 5

Hassan dies on 1 December 2019 leaving an estate of £500,000, including his home valued at £200,000, to his children.

He was divorced and there are no transferable NRB or RNRB available.

He has an NRB of £325,000 + RNRB of £150,000 (2019/20) = £475,000

We need to look back over a period of seven years prior to Hassan's death, beginning 2 December 2012.

Lifetime transfers: on 31 July 2019 Hassan transferred £200,000 into a discretionary trust.

Having made no previous gifts, Hassan is able to set his £6,000 combined annual gift exemptions for tax years 2019/20 and 2018/19 against the transfer:

Hassan's cumulative total is £194,000

Estate	£500,000
PLUS:	
Cumulative total	£194,000
	£694,000
LESS:	
NRB	(£325,000)
RNRB	(£150,000)
	£219,000
IHT @ 40%	**£87,600**

Although the above cumulates the lifetime transfer with the estate at death, in fact the NRB is set against the lifetime transfers first. It is perhaps easier (and more common) to do the calculation by reducing the NRB available to the estate by the cumulative total of lifetime chargeable transfers. It may be easier to re-work the above calculation as follows:

Estate	£500,000
LESS:	
NRB (£325,000 - £194,000 cumulative total)	(£131,000)
RNRB	(£150,000)
	£219,000
IHT @ 40%	**£87,600**

(Note that, although the NRB is set against lifetime transfers that become chargeable on death, it is not possible to set the RNRB against lifetime transfers, even if the transfer was of the deceased's qualifying residence).

Case study 6

Hassan dies on 1 December 2019 leaving an estate of £500,000, including his home valued at £200,000, to his children.

He was divorced and there are no transferable NRB or RNRB available.

He has an NRB of £325,000 + RNRB of £150,000 (2019/20) = £475,000

We need to look back over a period of seven years prior to Hassan's death, beginning 2 December 2012.

Lifetime transfers:

He has made the following gifts previously;

- 20 April 2008 – £250,000 discretionary trust
- 25 December 2010 – £100,000 gift to his daughter to help her buy a house
- 10 September 2012 – £5,000 gift to his son to help buy a second-hand car
- 21 August 2013 – £100,000 gift to his son to help him buy his first house
- 20 May 2015 – £100,000 discretionary trust
- 31 July 2019 – £200,000 discretionary trust

Dealing with these gifts in chronological order:

20 April 2008

- This was a CLT, but it is now more than seven years since Hassan made this gift.
- We can disregard this transfer.

25 December 2010

- This was a PET, but as it is now more than seven years since Hassan made this gift, it is now an exempt transfer.
- We can disregard this transfer.

10 September 2012

- This was an exempt transfer as it was within the 2011/12 & 2012/13 combined Annual Gift Exemptions of £6,000.
- The gift is also now outside our seven-year time frame.
- We can disregard this transfer.

21 August 2013

- This gift is within our seven-year time frame.
- It is now a failed PET, but we can reduce the gift by the £3,000 Annual Gift Exemption for the 2012/14 tax year[4], resulting in a chargeable transfer of £97,000.
- This transfer is included in Hassan's cumulative total.

20 May 2015

- This transfer is within our seven-year time frame and is a CLT.
- We can reduce the transfer by £6,000 (annual gift exemptions 2015/16 & 2014/15) resulting in a CLT of £94,000.
- This transfer is included in Hassan's cumulative total.

31 July 2019

- This transfer is within our seven-year time frame and is a CLT.
- We can reduce the transfer by £6,000 (annual gift exemptions 2018/19 & 2019/20) resulting in a CLT of £194,000.
- This transfer is included in Hassan's cumulative total.

Hassan's cumulative total is £385,000

Estate	£500,000
LESS:	
NRB (£325,000 – £385,000 cumulative total)	(£0)
RNRB	(£150,000)
	£350,000
IHT @ 40%	**£140,000**

We have dealt with the estate at death, but what about the tax charge on the lifetime gifts?

We should deal with the lifetime transfers separately and this is where the 14-year rule may apply.

The 14-year rule

Hassan dies on 1 December 2019 leaving an estate of £500,000, including his home valued at £200,000, to his children.

He was divorced and there are no transferable NRB or RNRB available.

He has an NRB of £325,000 + RNRB of £150,000 (2019/20) = £475,000

First, we need to look back over a period of seven years prior to Hassan's death, beginning 2 December 2012, for relevant lifetime transfers.

He has made the following gifts previously:

- 20 April 2008 – £250,000 discretionary trust
- 25 December 2010 – £100,000 gift to his daughter to help her buy a house
- 10 September 2012 – £5,000 gift to his son to help buy a second-hand car
- 21 August 2013 – £100,000 gift to his son to help him buy his first house
- 20 May 2015 – £100,000 discretionary trust
- 31 July 2019 – £200,000 discretionary trust

As you can see, only the gifts made on 21 August 2013, 20 May 2015 and 31 July 2019 become chargeable on Hassan's death. However, we cannot disregard all the gifts made before 2 December 2012.

Dealing with these gifts in chronological order:

20 April 2008

- This was a CLT of £244,000, but it is now more than seven years since Hassan made this gift.

25 December 2010

- This was a PET of £94,000, but as it is now more than seven years since Hassan made this gift, it is now an exempt transfer.

10 September 2012

- This was an exempt transfer as it was within the 2011/12 & 2012/13 combined Annual Gift Exemptions of £6,000.

21 August 2013

- This gift is within our seven-year time frame.
- It is now a failed PET, but we can reduce the gift by the £3,000 Annual Gift Exemption for the 2012/14 (tax year[4]) resulting in a chargeable transfer of £97,000.

20 May 2015

- This transfer is within our seven-year time frame and is a CLT.
- We can reduce the transfer by £6,000 (annual gift exemptions 2015/16 & 2014/15) resulting in a CLT of £94,000.

31 July 2019

- This transfer is within our seven-year time frame and is a CLT.
- We can reduce the transfer by £6,000 (annual gift exemptions 2018/19 & 2019/20) resulting in a CLT of £194,000.

Let's investigate the effect of the cumulative total on lifetime transfers chargeable on death.

21 August 2013 failed PET

This PET has now failed and has become a chargeable transfer.

To establish whether there is any tax due in respect of this transfer, we need to assess it, in addition to the cumulative total of chargeable transfers made by Hassan in the seven years prior to 21 August 2013.

This is a critical point and is at the heart of the 14-year rule: we must look back seven years from the date of the transfer, and not seven years from the date of death.

Cumulative total

The cumulative total for the gift made on 21 August 2013 includes the £244,000 CLT made on 20 April 2008.

(The 25 December 2010 and 10 September 2012 can be disregarded as they are now exempt transfers).

The total cumulative total for the 21 August 2013 failed PET is therefore £244,000.

21 August 2013 failed PET	£97,000
LESS:	
NRB (£325,000 - £244,000)	(£81,000)
	£16,000
IHT @ 40%	£6,400
Taper relief (80% as 6 – 7 years)	£5,120
IHT due	£1,280

Here you can see the effect of the 14-year rule in action: a CLT that was made more than seven years prior to the transferor's death still has an impact on the tax due on a chargeable transfer that was made within seven years.

This is because every chargeable transfer has its own cumulative total looking back seven years.

Using the example above, the 2008 CLT could have been made as far back as 22 August 2007 and still have been on the cumulative total for the 21 August 2013 transfer.

It is important to note that only CLTs can cast a shadow over 14 years, a PET made more than seven years prior to death becomes exempt and will not be included in a cumulative total.

20 May 2015 CLT

Cumulative total:

Includes 21 August 2013 failed PET of £97,000

The CLT of 20 April 2008 has fallen out of account, as it is more than seven years prior to 20 May 2015.

The cumulative total for the 20 May 2015 CLT is therefore £97,000.

20 May 2015 CLT	£94,000
LESS:	
NRB (£325,000 – £97,000)	(£288,000)
	£0
IHT @ 40%	£0
IHT due	**£0**

31 July 2019 CLT

Cumulative total

Includes 21 August 2013 failed PET of £97,000, and includes 20 May 2015 CLT of £94,000

The CLT of 20 April 2008 has fallen out of account, as it is more than seven years prior to 20 May 2015.

The cumulative total for the 20 May 2015 CLT is therefore £97,000.

31 July 2019 CLT	£194,000
LESS:	
NRB (£325,000 – (£97,000 & £94,000)	(£134,000)
	£60,000
IHT @ 40%	£24,000
Taper relief (0% as less than 3 years)	£0
IHT due	**£24,000**

Section 2: The order of gifts

A client may have made exempt transfers, PETs and CLTs in the seven years prior to death.

Potentially Exempt Transfers

PETs will only become chargeable on death if they 'fail' because the donor died within seven years of making the gift.

Chargeable lifetime transfers

By contrast, a CLT may give rise to a charge to IHT:

- In the settlor's lifetime,
- On their death and (in the case of a trust),
- Every ten years (periodic charge/principle charge) and
- When capital is appointed out of the trust (exit charge/ proportionate charge)

The order of gifts may not affect the quantum of the IHT charged when lifetime transfers are made or on the transferor's death. So, what then, is the significance of 'the order of gifts'?

The order of gifts may affect the periodic charge of relevant property trusts settled by the deceased and this is probably best explained with an example.

Case study 1

Marcio, having never made previous gifts, made the following gifts:

- £250,000 gift to his son – this is a PET
- £300,000 into a discretionary trust – this is a CLT

Marcio was able to make one gift in October 2019 and the other in November 2019.

Assuming Marcio dies in December 2024 (2024/25 tax year), what would be the IHT position in respect of the two gifts, and how would it differ depending upon whether the PET or the CLT were made first?

Assuming the NRB in the 2024/25 tax year increased to £359,000 (CPI from April 2021 assumed 2.5%)

SCENARIO 1: PET made before the CLT

The PET

As the PET was the first transfer, it benefits from the 2019/20 and 2018/19 annual gift exemptions.

The PET value is therefore £250,000 – £6,000 = £244,000.

£244,000 is less than the NRB of £359,000 therefore attracts no IHT.

The CLT

The PET, being the earlier transfer, has used up £244,000 of the NRB leaving £115,000.

£115,000 of the £300,000 CLT is covered by the NRB, leaving £185,000 taxable

CLT	£300,000
LESS:	
NRB (£359,000 – £244,000 failed PET)	£115,000
	£185,000
IHT @40%	£74,000
Taper relief (5 – 6 years) 60%	£44,400
Tax due	**£29,600**

SCENARIO 2: CLT made before the PET

The CLT

As the CLT was the first transfer, it benefits from the 2019/20 and 2018/19 annual gift exemptions.
The CLT value is therefore £300,000 – £6,000 = £294,000.
£294,000 is less than the NRB of £359,000, therefore attracts no IHT.

The PET

The CLT, being the earlier transfer, has used up £294,000 of the NRB, leaving £115,000.
£65,000 of the £250,000 PET is covered by the NRB, leaving £185,000 taxable.

Failed PET	£250,000
LESS:	
NRB (£359,000 – £294,000 failed PET)	£65,000
	£185,000
IHT @40%	£74,000
Taper relief (5 – 6 years) 60%	£44,400
Tax due	**£29,600**

The tax liability on Marcio's death is the same, irrespective of the order of the gifts, but the order does affect where the liability rests.

Let's project forward 10 years: the discretionary trust is due its first periodic review.

Let's assume the trust assets are now worth £450,000 and the NRB is £406,000.

SCENARIO 1: the PET was made first

Value of trust property	£450,000
Previous cumulative total (failed PET)	£244,000
	£694,000
Less NRB	(£406,000)
	£288,000
@ 20% lifetime IHT rate	£57,600
Effective rate	12.8000% (57,600/£450,000 x 100)
Settlement rate	3.8400% (12.8000 x 30%)
Periodic tax charge	**£17,280** (£450,000 x 3.84000%)

SCENARIO 2: the CLT was made first

Value of trust property	£450,000
Previous cumulative total	£0 (as failed PET made after the CLT)
	£450,000
Less NRB	(£406,000)
	£44,000
@ 20% lifetime rate	£8,800
Effective rate	1.9556 (£8,800/£450,000 x 100)
Settlement rate	0.5867 (1.9556 x 30%)
Periodic tax charge	**£2,640** (£450,000 x 0.5867%)

As is evident from the above example: while the order in which Marcio made the gifts did not affect the amount of IHT due on his death, it did determine who was liable for tax and it did affect the periodic review for the trust.

Multiple gifts as part of an estate planning exercise

A client may make various gifts as part of an estate planning exercise. Some gifts may be PETs, some may be CLTs and some may be exempt transfers. Where the client has plans to make a series of gifts, including settlements into relevant property trusts, it is worth considering the effect that the order of gifts may have on future periodic charges over a foreseeable period.

To minimise future periodic tax charges, it would be beneficial to arrange gifts such that, when the trust periodic charge arises, the cumulative total has been kept to a minimum. Consider the following example.

Grace is looking to make the following arrangements as part of an estate planning exercise:

- Regularly gifting £20,000 of her excess income into a discretionary trust for her nieces and nephews
- A discretionary loan trust with a loan of £200,000 for her cousins
- A £200,000 transfer into a discretionary gift trust for her children
- A £200,000 gift into a bare trust for school fees for her grandchildren

Continued

Assuming Grace were to die within 7 years of establishing these arrangements, what is their IHT status?

- The gifts from regular income into the excess income trust should be exempt transfers, assuming they satisfy the Normal Expenditure Out of Income (NEOI) requirements (IHTA 1984 s21)
- The loan into the loan trust was not a transfer of value, as it was a loan and not a gift
- The transfer into the discretionary gift trust was a CLT
- The gift into the bare trust was a PET, but would become a chargeable transfer if Grace dies within seven years of the gift

The proposed order

1. Loan trust
2. Surplus income trust
3. Discretionary gift trust
4. Bare trust

Consider future periodic reviews

Loan trust

- value of trust property
- minus outstanding loan to Grace
- no cumulative total

Surplus income trust

- value of trust property
- no cumulative total, as loan trust did not involve a transfer of value

Discretionary gift trust

- value of trust property
- no cumulative total as
  - loan trust did not involve a transfer of value and
  - gifts of income into excess income trust were exempt transfers

Bare trust

- no periodic charge

As you can see, we have kept the cumulative total to a minimum by putting the exempt transfers and loan trust first, followed by the CLT followed by the PET. Rearranging the order would create a cumulative total for one or more of the discretionary trusts where there currently is none.

Note: we have suggested the loan trust to be established before the excess income trust, this order could be reversed, but there is always a risk that HMRC may challenge a NEOI claim. This could render the gifts into the excess income trust CLTs.

Notes

[1] Some dispositions are not regarded as transfers of value for IHT purposes, such as those made for the maintenance of family, those not intended to confer a gratuitous benefit or contributions to a registered pension scheme or Qualifying Non-UK Pension Scheme etc: refer IHTA1984 SS18 – 27A

[2] refer to IHTA 1984 ss18 – 29A

[3] the definition of a PET can be found at IHTA1984 s3A

[4] The sum of chargeable transfers within this seven-year period prior to the current chargeable transfer is referred to as the "cumulation" or "cumulative total" and is included in the IHT calculations for:

- Chargeable lifetime transfers,
- The charge to IHT on death,
- Periodic charges for Relevant Property trusts.

[5] Although the £5,000 gift made in the 2012/13 tax year only used up £5,000 of the £6,000 annual gift exemptions available in respect of 2011/12 and 2012/13, the 2012/13 exemption is used first – meaning none of the 2012/13 exemption can be carried forward to 2013/14.

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