Inheritance tax and the order of gifting

Synopsis: Inheritance tax planning and trust planning can be very complex. However its essential that you understand the implication of making gifts and in what order they should be made.

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When your clients make a gift, it will generally be either a potential exempt transfer (PET) or a chargeable lifetime transfer (CLT).

PETs

A PET is an outright gift between individuals of an asset, cash or a gift into a bare/absolute trust. There is no limit to the value of cash or asset gifted from one individual to another. There are no inheritance tax (IHT) charges to worry about when setting up a PET nor are there any ongoing charges associated with PETs.

Remember, your client cannot benefit in any way whatsoever from the gift. Otherwise, it may be classed as a gift with a reservation of benefit (GWR) and will still form part of their estate on death.

Once the gift is given to a beneficiary, it will form part of the beneficiary's estate for inheritance tax purposes, death, bankruptcy and divorce.

CLTs

The most common CLT is a transfer into a discretionary trust and each individual can gift up to £325,000 in a seven-year rolling period before an entry charge applies. Discretionary trusts may also be subject to an IHT charge every ten years called the periodic charge, and when distributions are made from the trust fund which are called exit charges. These calculations can be difficult for trustees to calculate.

However, discretionary trusts do not always have to be complex, i.e. if they are set up within the client's available nil rate band there will be no entry charge. If, when you set up a discretionary trust, there is no entry charge there will be NO exit charges within the first ten years.

Order of gifts

What is the best order to make gifts, is it a PET then a CLT or is it a CLT and then a PET, or does it actually matter?

Consequences of making a PET before a CLT

If a client makes a gift of cash/assets or sets up an absolute trust and dies within seven years of the gift, the PET becomes a chargeable transfer. This has an impact on any CLTs created after the PET.

When you calculate the periodic or ten-yearly charge on a discretionary trust you need to know what nil rate band (NRB) is available for the trust. In simplistic terms, if the value of the trust fund at the ten-year point exceeds the "available" NRB for the trust there will be an IHT charge applied to the trust of no more than 6% of the excess.

This means it is important for the trust to have as much of a NRB as possible to use at every 10th anniversary.

So, how do you work out what the NRB is for the trust?

You work this out by going back to the start date of the discretionary trust and look for any previous CLTs created in the seven years before the trust was set up. If there are none, it means the trust, throughout its lifetime, will have 100% of whatever the NRB is at each ten-year point.

However, a failed PET becomes chargeable and eats the NRB that the client needs now and at every ten-year point, going forward for the trust.

Case study

Helen gifts her son Connor £100,000 to help him get on the property ladder. She already uses her £3,000 annual IHT gifting exemption each year. This gift to Connor will be a PET for £100,000. She sets up a discretionary gift trust three years later (this is her first gift into trust) for £300,000 for IHT planning reasons and so she can leave a legacy for future generations.

If Helen were to die two years later, the PET would fail (set up five years before death) and become chargeable. This means that, at every ten-year point, instead of having 100% of the NRB throughout the lifetime of her discretionary trust, it will be reduced by £100,000. So, in this scenario, you can see that, instead of her discretionary trust having a full NRB at each 10th anniversary, it will now be reduced each time by £100,000, which means there is more chance of a periodic charge applying every ten years.

Consequences of making a CLT before a PET

Generally, PETs and CLTs drop out of the IHT cumulation after seven years, so if a client sets up a discretionary trust and creates a CLT it will normally drop out of their IHT calculation after seven years. However, if they make a gift of cash and create a PET after the setup of the trust, this can expand the timeline for the CLT beyond the seven years and can potentially keep the CLT in the timeline for up to 14 years.

Under the complex IHT rules, it states that if a PET fails and becomes chargeable from the date of that gift, you look back seven years and pull in any previous CLTs.

Case study

If Helen sets up her discretionary gift trust first for £300,000, she expects this to drop out of her IHT cumulation after seven years. However, three years after setting up the trust, her son Connor decides to buy a house and Helen gifts him £100,000 to help him out. Remember, this cash gift is a PET.

The impact of the PET is that, instead of her £300,000 dropping out of her cumulation after seven years, it is now going to be included for the same length of time as the PET. This means it will not drop out of her IHT calculation for ten years!

Best client outcome

There are implications either way when doing IHT planning for clients where there is a mixture of PETs and CLTs. The best way to create gifts is to do the CLT first and then soon afterwards create the PET. This means that you are not expanding the timeline by much for the CLT and it gives the discretionary trust the maximum nil rate band at each ten-year anniversary.

Do not forget about loan plans

Loan plans are not a transfer of value so if you are doing a combination of discretionary gift trusts and loan plans the best order is to do the loan plans first and then the gift trusts. The reason being is that, as the loan plan is not a transfer of value, it will not eat into the NRB for the gift trust which means generally both trusts will have 100% of the NRB at each ten-year point.

Conclusion

When you are carrying out IHT planning for clients you ought to be aware of the impacts of the order of gifts. If you set up a discretionary trust for a client, it is really important that you inform them that by making cash gifts out with their exemptions and therefore creating PETs this can expand the time line on their discretionary trust.

Remember, clients generally just give cash to family and will not think to talk to you first, so you need to remind them that after setting up their discretionary trust any cash gifts made after will expand the seven-year clock on their gift into trust.

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