

The inheritance tax 14-year rule

Synopsis: A reminder of how the “14-year rule” operates for inheritance tax purposes.

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It is commonly known that, when an individual makes a gift, provided they survive seven years from the date of making the gift, the gift will generally fall out of account for inheritance tax (IHT) purposes.

However, the “seven-year rule” is modified where a series of gifts are made and the settlor dies within seven years of making such gifts; more specifically where a chargeable lifetime transfer (CLT) is made up to 14 years before the death of the settlor which results in an IHT liability on a subsequent failed potentially exempt transfer (PET) or second CLT.

What follows is an explanation and example of how this “14-year rule” operates in practice.

Ignoring any exempt transfers, it is possible for an individual to make either PETs or CLTs for IHT purposes.

A PET is usually made outright to an individual (including a bare/absolute trust) and would not involve any immediate lifetime IHT being payable. Whereas a CLT is usually made through the creation of a trust which is flexible/discretionary in nature and could result in IHT being payable if the amount transferred exceeds the settlor’s available nil rate band.

The available nil rate band for these purposes is the current nil rate band reduced by other CLTs made by the settlor in the seven years prior to creating the trust – note PETs are ignored for these purposes.

When a PET is made in lifetime, if the person making the gift dies within seven years, it becomes chargeable. In addition, while a CLT is chargeable when made, IHT may not have been payable at the time it was made, although if death occurs within seven years of making it, there may be IHT (or additional IHT) to pay.

The important point to note is that when determining the amount of nil rate band available to set against such gifts (either PETs or CLTs) it is necessary to look at all chargeable transfers – which then include any failed PETs - made in the seven years before that gift – in other words it is necessary to look back up to 14 years.

In addition, the position both upon death and in lifetime has to be determined.

This is best illustrated by an example...

Each year, Bill makes use of his annual exemption of £3,000 and, in addition, Bill has made the following gifts...

- 18 July 2013 - £100,000 to a discretionary trust.

- 1 October 2016 - £150,000 to his son.
- 15 April 2018 - £150,000 to his daughter.

Bill dies on 10 June 2022 leaving an estate of £400,000.

The nil rate band for 2022/23 is £325,000.

Position in lifetime

The transfer into trust 18 July 2013 is within the nil rate band (£325,000 for 2013/14) so no lifetime IHT would have been payable.

The other two gifts to Bill's son on 1 October 2016 and daughter on 15 April 2018 are PETs so, again, no lifetime IHT would be payable.

Position on death

The transfer into the discretionary trust on 18 July 2013 was more than seven years before Bill's death, so would not be subject to IHT.

The gift to his son on 1 October 2016 has become chargeable, as Bill died within seven years. However, as the cumulative total of this gift (of £150,000) and the previous gift into trust of £100,000 is all within the nil rate band amount of £325,000 no IHT would be payable as a result of this PET becoming chargeable on death.

The gift to his daughter on 15 April 2018 has also become chargeable, as Bill died within seven years. However, in this case, the earlier gifts would need to be taken into account to determine the position as follows...

PET

£150,000

Nil rate band on death £325,000

Less chargeable transfers in the previous seven years

- Gift into trust (£100,000)
- Gift to son (£150,000)

Remaining nil rate band
£75,000

Chargeable
£75,000

IHT £30,000

Less taper relief (4/5 years) (£12,000)

Payable by the daughter £18,000

Therefore, while the transfer into trust was made nearly ten years prior to Bill's death it still has an impact when determining the available nil rate band which could be applied against the gift to Bill's daughter and resulted in a tax liability of the failed PET.

Note, for the purposes of calculating the IHT liability on Bill's death estate, only the two PETs would have an impact as the gift into trust had fallen out of account. Thus, in this case, the nil rate band available to apply against the death estate would be £25,000 (i.e. £325,000 - £150,000 - £150,000).

Comment

This paper should not only serve as a reminder regarding the IHT treatment of lifetime gifts, but also prompt advisers to explain the repercussions of the "14-year rule" to their clients prior to them making a series of lifetime gifts.

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