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LIFE INSURANCE SPECIALISTS

IHT exemptions

Synopsis: Description of IHT exemptions available.

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Transfers between the parties to a marriage/civil partnership - S18 IHTA 1984

Transfers between UK domiciled parties to a marriage and between civil partners are exempt from inheritance tax (IHT) without limit, whether they are lifetime transfers or transfers on death, provided that the property transferred becomes comprised in the donee spouse's/civil partner's estate.

Please see IHTM11032 for a useful definition of spouse and civil partner.

Prior to 22 March 2006, this included lifetime transfers into a trust where the spouse/civil partner had an interest in possession. For such trusts created after that date the spouse/civil partner exemption will not apply as such trusts are taxed under the relevant property regime for IHT purposes. However, when such a trust is created on death (an immediate post-death interest - IPDI), the spouse/civil partner exemption will continue to apply.

Where the spouse or civil partner making the gift or bequest is domiciled in the UK for the purposes of IHT and the donee spouse or civil partner is domiciled abroad, this exemption is a cumulative total of £325,000 (increased from £55,000 by the 2013 Budget).

Individuals who are domiciled outside the UK and who have a UK domiciled spouse or civil partner can now elect to be treated as domiciled in the UK for the purposes of IHT.

Example

A married couple (Sam and Alex), both UK domiciled, make Wills each leaving the entirety of their respective estates on death to the surviving spouse. Neither has made any lifetime gifts. Assuming Sam dies first with an estate of £1 million, this would pass to Alex and there would be no IHT payable. If, in the above example, Alex was not domiciled (and had not elected to be treated as domiciled) in the UK, there would be IHT due as follows. (The same would apply if Sam and Alex were in a civil partnership together instead of being married)...

Transfer	£1,000,000
Less spouse/civil partner exemption	(£325,000)
Less nil rate band	(£325,000)
Chargeable	£350,000
Tax due	£140,000

The exemption is not available where the gift or bequest is not immediately in favour of the spouse/civil partner, or the transfer is made dependent on a condition that is not satisfied within twelve months.

Relief is not excluded merely because the gift is dependent on the recipient surviving the other spouse/civil partner for a specified period of up to six months, so, for example, where a Will is drawn so that the widow is not to benefit unless she survives her husband for (say) twenty-eight days, the exemption will apply if she does so survive.

Annual exemption - S19 IHTA 1984

Lifetime gifts are exempt up to a total of £3,000 for each donor in a year. A year means a period of 12 months ending on 5 April (i.e. a tax year). If an outright gift to an individual is eligible for the annual exemption, it is an exempt transfer and not a potentially exempt transfer (PET) to the extent it is covered by the annual exemption.

Any part of the exemption not used in one year can be carried forward to the next following year only. In calculating the unused balance of the exemption for any year, gifts in that year are set against the exemption for that year in priority to any unused balance carried forward. If gifts exceed the exemption limit for that year, they are counted towards the limit in chronological order (if more than one gift is made on the same day the exemption is apportioned between them if necessary).

Example

Anna made no gifts in 2022/23. The £3,000 exemption due for that year is carried forward and allowed along with the £3,000 exemption for 2023/24 to give a total of £6,000 for that year.

Example

A gift of £1,600 is chargeable when made by Alison in June 2021. This is set against Alison's 2021/22 exemption of £3,000. The balance of £1,400 is carried forward to 2022/23. A further gift of £1,800 is chargeable when made by Alison in May 2022. The amount that can be carried forward to 2023/24 is £1,200 (i.e. £3,000 less £1,800). The £1,400 unused exemption from 2021/22 ceases to be available.

Example

Andrew makes an outright gift of £10,000 in June 2022. He made no gifts during the 2021/22 tax year. In October 2022 he makes a further gift into a discretionary trust, which is a chargeable transfer when made. The annual exemption for 2022/23 and the carried forward allowance from 2021/22 are set against the first £6,000 of the June gift leaving the balance of £4,000 as a PET. The whole amount of the October gift made into the discretionary trust becomes a chargeable transfer.

It should be noted that certain rules exist to determine when a gift is actually effective. These rules depend on the asset that is being gifted.

To ensure that a gift is made before the end of the tax year, the gift must take effect before 6 April. The date when the gift is made is also, of course, relevant for the purpose of calculating when the seven-year period from the gift starts running – especially for PETs. The individual must survive the gift by seven years for it to fall out of the account for IHT purposes.

The effective date of gift depends on the type of asset being given and the method of transfer. In addition, to effectively transfer title to certain assets, certain formalities may have to be satisfied.

Generally speaking, under English law, a gift is regarded as effective when the donor has done everything necessary to transfer to the donee the ownership of the property intended to be gifted. For example, in the case of a shareholding being gifted, the gift would be effective when the donor has given to the donee the stock transfer form and the share certificate. The effective date will therefore fall before the shares are registered in the name of the new owner.

Where shares are held by a nominee, the legal method of transfer is by an instrument in writing, usually a deed of assignment, and a notice to the nominee. Again, once the documents have been handed over to the donee, the transfer will be effective.

Where larger gifts are involved, e.g. assets such as land or leases of land, there may have to be certain legal formalities to be satisfied before the transfer can be effective, for example the obtaining of a licence from the landlord etc. All these formalities must be satisfied before a legal transfer is effective.

To transfer a life assurance policy, a deed of assignment is necessary and a notice to the life assurance company. The effective date will be the date the deed of assignment is executed.

When cash or chattels are being gifted, generally speaking, this is done simply by physical delivery and so it will be the date of delivery that will be the date of the gift.

What happens if a gift is by cheque? Unfortunately, this is where an exception to the general rule mentioned above exists and this is where potential problems may arise for potential donors. This is because the effective gift takes place not when the donor has done everything that is necessary of them (i.e. signed and handed over the cheque), but when the cheque is actually cleared and the funds are debited from the donor´s account and credited to the donee´s account.

This was confirmed in the case of Curnock –v- IRC (SPC 365). This point is of particular importance because most transfers into trust, where cash is involved, are done by cheque.

In light of the above, it may be that the definition of "last minute" planning needs to be somewhat revised, especially where the intended gift is to be made by way of cheque. This will be particularly so where it is intended, for example, to create a trust with the intention that the trustees should invest in a particular company and the gift is being satisfied with a cheque given to the trustees by the settlor and made payable to the investment company in question.

In such a case, the trustees would then generally complete an application form and forward it with the settlor´s cheque to the investment company. Thus, the period from the settlor completing the trust declaration and handing over the cheque to the trustees to the cheque actually clearing the settlor's account may be several days.

Clearly, if it is important that annual IHT exemptions are utilised for the purpose of any gifting, the planning should not be left until the last minute.

Small gifts - S20 IHTA 1984

Lifetime gifts, which a person makes, are exempt from IHT up to a total of £250 to each recipient in any tax year. This exemption is available only if the total of all gifts made by the donor to the donee in any tax year does not exceed £250.

It is not possible to use both the £3,000 annual exemption and the £250 annual exemption in respect of the gifts to the same donee in the year.

Normal expenditure out of income - S21 IHTA 1984

Lifetime gifts, other than gifts with a reservation of benefit (please see Gifts with reservation), are exempt to the extent that they are made out of the donor's income.

To qualify for this exemption the donor must show that...

- The transfer was part of their normal expenditure.
- Taking one year with another it was made out of income.
- After the gift the donor was left with sufficient income to maintain their usual standard of living.

A gift is regarded as part of the donor's 'normal' expenditure if its amount and type are consistent with their usual pattern of gifts. 'Normal' is regarded as broadly equivalent to typical or habitual.

The first gift in a series can qualify as 'normal' provided that there is clear evidence that further gifts are intended (even if they are not subsequently made), so the exemption could cover an initial gift under a deed of covenant or some similar regular commitment such as the first of a series of premiums on a life insurance policy written subject to trust. If there is no such evidence, but further similar gifts

are in fact made, the first gift of the series can qualify retrospectively for exemption.

Many of the life policy trusts created before 22 March 2006 were flexible power of appointment trusts, which were taxed as interest in possession trusts. As such, HMRC Inheritance Tax would not normally agree the normal expenditure exemption at the time the premiums were paid because the transfers may not become chargeable.

Given that many trusts of life policies taken out from 22 March 2006 onwards will now fall into the discretionary trust regime, and such transfers will be chargeable during lifetime, HMRC should be able to agree the normal expenditure exemption as and when the premiums are paid.

'Income', for the purposes of the exemption, means net income after income tax and is determined in accordance with normal accountancy rules (rather than income tax rules).

Income is measured 'taking one year with another' and accordingly the exemption is not lost merely because of fluctuations of income from one year to another. Nor would it be lost if the donor used income to make a gift, and, having met some exceptional expense, was temporarily obliged to resort to capital to meet ordinary living expenses, the depletion of capital later being made good. In practice, the 'out of income' test is regarded as satisfied if the donor can show that they could have made the gift out of income after meeting living expenses.

But gifts of property other than cash do not qualify for the exemption unless the donor can show that the property was purchased out of income in order to make the gift.

In Bennett and others v Inland Revenue Commissioners (1995 STC 54) it was held that the term “normal expenditure” connotes expenditure which, at the time it took place, accorded with the settled pattern of expenditure adopted by the donor.

The existence of such a settled pattern might be established either: (i) by reference to a sequence of payments by the donor out of past expenditure; or (ii) by proof of a prior commitment or resolution adopted by the donor regarding his future expenditure.

In the Bennett case, the donor had a life interest in a trust fund and gave the trustees instructions to transfer all the surplus income to the donees above what was reasonably required to maintain her standard of living. Mrs Bennett had a modest lifestyle.

She died after making two gifts of £28,000 and £180,000 out of her surplus income. It was held that the donor had established a pattern of expenditure in respect of the surplus income, and the payments to the donees had been made in accordance with that pattern and were accordingly part of her normal expenditure within the meaning of S21 IHTA 1984.

The capital element of a purchased life annuity bought after 12 November 1974 is not regarded as part of the donor's income for this purpose (S21(3) IHTA 1984). If a person effects an annuity and pays premiums on a life insurance policy for the benefit of someone else, the exemption is not available if the taking out of the policy and the purchase of an annuity were associated operations which would have given rise to a charge under S263 IHTA 1984.

In 2011, as part of an update to the Inheritance Tax Manual, (IHTM14250), HMRC confirmed that withdrawals (i.e. part surrenders) from single premium investment bonds are treated as capital for the purposes of the normal expenditure out of income exemption.

Wedding/civil partnership gifts - S22 IHTA 1984

Gifts in consideration of marriage or a civil partnership are exempt from IHT up to a limit, which varies according to the relationship between the donor and the parties to the marriage/civil partnership. To qualify for the exemption, the gift must be to one or both of the parties to the marriage/civil partnership and it must be a lifetime gift.

The exemption limits are...

- £5,000 if the donor is a parent of one of the parties to the marriage/civil partnership.

- £2,500 if the donor is one of the parties to the marriage/civil partnership or a grandparent or remoter ancestor of one of them.

- £1,000 for any other gift.

The limits for gifts by the parties to the marriage/civil partnership (once they are married/in a civil partnership) are not relevant where they are both domiciled in the UK since the spouse/civil partner exemption will apply.

The exemption applies both to outright gifts and gifts to marriage/civil partnership settlements. But a marriage/civil partnership settlement would not normally qualify for the exemption if the persons entitled to benefit from it were other than those being married, or forming a civil partnership, their issue, and the spouse or civil partner of any issue. The exemption is confined to gifts that become fully effective only on the marriage/civil partnership.

Gifts to charities and other approved bodies

i. Gifts and bequests to charities are wholly exempt from IHT - S23(1) IHTA 1984. In addition, where the total amount left to charity by a deceased is 10% or more of the deceased's net estate then the rate of IHT payable on the rest of the estate can be reduced by 10%.

Note that in the March 2023 Spring Budget it was announced that the definition of a charity would be restricted to UK charities. EU and EEA charities and Community

Amateur Sports Clubs that HMRC has not previously accepted as qualifying for charitable relief will be prevented from claiming UK tax reliefs from 15 March 2023. A transitional period will apply until 1 April 2024 for EU and EEA charities that HMRC has previously accepted as qualifying for relief.

So, for the purposes of IHT, this applies in relation to transfers of value made on or after 1 April 2024. However, if the charity has not asserted its status as a charity before 15 March 2023, this applies for the purposes of IHT, in relation to transfers of value made on or after 15 March 2023. A body of persons or trust has "asserted its status as a charity" if - (a) immediately before 15 March 2023 it falls within the definition of "charity" in Part 1 of Schedule 6 to FA 2010, and (b) at any time before that date, it has (under any enactment) made a valid claim to HMRC in reliance on its status as a charity.

ii. Gifts and bequests to political parties are also exempt - S24(1) IHTA 1984. A political party qualifies for this exemption if two of its members were elected to the House of Commons at the last general election before the gift, or if one of its members was elected and at least 150,000 votes were cast for its candidates.

iii. Gifts and bequests to national museums, universities, the National Trust and certain other bodies (Gifts for public benefit) are exempt - S25(1) IHTA 1984 and Schedule 3 IHTA 1984. There is also an exemption for transfers for the maintenance of historic buildings (S27 IHTA 1984).

iv. Gifts and bequests made before 17 March 1998 of national heritage property to a suitable non-profit-making body, where approved by the Board of Inland Revenue, were exempt - S26(1) IHTA 1984. This exemption applied to...

- Land of outstanding scenic, historic or scientific interest.
- Buildings of outstanding historic, architectural or aesthetic interest, together with land used as the grounds of the building and objects kept in and given with the building.
- Works of art and similar objects of national, scientific, historic or artistic interest.
- Property given as a source of income for the upkeep of any of these items.

This exemption has been removed as the gradual widening of the scope of the exemption for charitable gifts and bequests had rendered it largely redundant.

v. Gifts of land in the UK to Registered Housing Associations on or after 14 March 1989 are exempt - S24A IHTA 1984.

The exemptions for transfers to charities and other bodies referred to above do not apply to...

- Defeasible gifts (broadly, gifts which can be terminated by a future event).

- Gifts for a limited period.
- Gifts of less than the donor's full interest in the property.
- Gifts which may become applicable for other than charitable or other exempt purposes.
- Gifts out of a settlement in which an interest has been acquired for a consideration by an exempt charity or other body.

Where the property is land or buildings, the exemption does not apply if an interest has been reserved or created by the donor which entitles the donor, the donor's spouse, civil partner or any person connected with the donor, to possession or occupation of the property otherwise than at the full arm's length (commercial rate of) rent.

In the case of property other than land or buildings, the exemption does not apply if the interest reserved or created by the donor was for less than full monetary consideration and substantially affected the enjoyment of the gifted property by the donee.

Where there is a gift to a charity or other body of a life interest in settled property, the exemption does not apply unless the recipient body has already been given the remaining interest in the property.

These exceptions require that the donor is obliged to part with their whole interest in the transferred property, and cannot affect the enjoyment of those to whom it has been given.

Gifts for maintenance of the family - S11 IHTA 1984

Lifetime gifts for the maintenance of a spouse, civil partner, child or dependent relative of the donor are exempt from the tax in certain circumstances. A gift for the maintenance of a spouse or civil partner, or former spouse/civil partner, is exempt unconditionally.

A gift for the maintenance, education or training of a child of either the donor or the donor's spouse/civil partner is exempt provided that it is for the child's maintenance, education or training up to the age of eighteen or until completion of full-time education if later.

Similarly, a gift made for the maintenance, education or training of a child who is not in the care of either parent is exempt until the child attains age eighteen. If the child has been in the care of the person making the disposition for substantial periods, the exemption can be extended until the child has completed their full-time education or training.

These exemptions are available also for gifts to stepchildren, illegitimate children and adopted children.

A gift made to a dependent relative of the donor is exempt to the extent that it makes reasonable provision for the relative's care or maintenance.

'Dependent relative' means any relative of the donor (or spouse/civil partner) who is unable to maintain themself because of old age or infirmity. It also includes the donor's mother or mother-in-law whether or not she is elderly or infirm unless she is living with her spouse/civil partner.

Transfers by close companies to employee trusts - S13 IHTA 1984

A transfer of property by a close company to the trustees of an employee trust may be exempt from IHT provided that a majority of all the employees of the company or any of its subsidiaries are included among the beneficiaries and that major participators in the company cannot benefit under the trust.

Major participators are those who have beneficial entitlement to, or rights to acquire, 5% or more of the shares, and would be entitled to 5% or more of the company's assets in the event of the company winding-up.

Transfers by individuals to employee trusts - S28 IHTA 1984

A transfer of shares in a company by an individual during lifetime or on death to a trust for the benefit of the employees of that company can also qualify for exemption from IHT if...

- The trustees hold more than one half of the ordinary shares in the company; and...

- The trustees have voting control of the company and there is nothing that can wrest this control away from them without the consent of the trustees; and...

- A majority of all the employees of the company or any of its subsidiaries are included among the beneficiaries; and...

- Major participators in the company (please see "Transfers by close companies to employee trusts" above) cannot benefit under the trust.

Dispositions which are not transfers of value

Certain types of transfers made by a donor during lifetime are not regarded as 'transfers of value', and so they are exempt from IHT. These exemptions are not applicable to transfers made on death.

i. Dispositions not intended to confer gratuitous benefit

For a disposition where it can be shown that it was not the donor's intention to confer any gratuitous benefit on any person, and that the transaction was either at arms length between unconnected persons, or was carried out on normal commercial terms, there will be no element of gift.

Consequently, such a transfer is not a transfer of value, (S10 IHTA 1984). Connected persons are essentially a spouse or civil partner or other relative (including uncle, aunt, nephew and niece) and certain trustees and business associates.

This rule does not apply where a person with an interest in possession acquires a reversionary interest expectant.

The rule only applies to a sale of unquoted shares or debentures if it can be shown that the sale was at a price freely negotiated at the time of the sale (S10(2) IHTA 1984).

It is not sufficient, for example, that they were sold at a price which had been fixed under a provision of the company's Articles of Association, but, if the parties to the transfer are at arm's length and have agreed, say, in the context of a shareholder's agreement (i.e. a fixed price or a price calculated by reference to a formula), when the transfer actually takes place no transfer for IHT will arise.

ii. Dispositions allowable for income tax or corporation tax

If a person (including a close company) makes a disposition that is allowable as a deduction in working out profits or gains for income tax or corporation tax purposes, it is not subject to IHT - S12(1) IHTA 1984.

iii. Provision for retirement benefits

If an employer makes contributions to a registered pension scheme providing retirement benefits to an employee for their service, the contributions are not subject to IHT, whether or not they are allowable as a deduction for income tax or corporation tax purposes - S12(2)(a) IHTA 1984.

If, instead, they provide comparable retirement benefits in some other way for an employee (or for the employee's widow or widower or dependants after death), the disposition the employer makes is exempt from IHT to the extent that the benefits provided by it are no greater than could have been provided under a registered pension scheme - S12(2)(b) IHTA 1984 and S12(3) IHTA 1984.

If both types of benefit are provided (i.e. approved and otherwise) then, so long as the total benefit obtainable under both is not greater than the benefits which would be obtainable under only one of the two, it will not be a transfer of value.

This exemption does not apply if the employer and the employee are 'connected'.

There is also an exemption for a contribution under registered personal pension arrangements entered into by an employee of the contributor - S12(2)(c) IHTA 1984.

iv. Waiver of remuneration

A waiver or repayment of remuneration is not subject to IHT if the remuneration would have been liable to income tax if it had not been waived or repaid.

It is a condition of the exemption that the remuneration waived or repaid is not allowed as a deduction in working out the employer's profits for income tax or corporation tax purposes - S14 IHTA 1984.

v. Waiver of dividends

If a person who would be entitled to a dividend on shares in a company waives their right to the dividend within twelve months before the right has accrued, the waiver is not subject to IHT - S15 IHTA 1984.

vi. Changes in the distribution of deceased's estate

The following changes in the distribution of a deceased's estate are not transfers of value...

- A variation or disclaimer made within two years of death.
- A transfer within two years of death in accordance with a testator's wishes, but not made under the terms of their Will.
- An election by a surviving spouse or civil partner to have a life interest redeemed where the deceased died intestate.
- The renunciation (in Scotland) to a claim to legitim within a specified period.

At Budget 2015, the then Chancellor announced that the Government would review what he described as attempts to avoid IHT through the use of deeds of variation. Initial consultations were launched into the tax planning uses of deeds of variation although, to date, no further action has been taken.

Excluded property

Excluded property is property which is outside the scope of IHT, so that a transfer of such property is ignored for IHT purposes. So, whilst strictly speaking this is not the same as being "exempt" within the specific statutory exemptions mentioned above, the net result is the same.

The main types of excluded property are...

- Property outside the UK held by a non-UK domiciled person.
- Settled property situated outside the UK if the settlor was non-UK domiciled when the settlement was made.
- A reversionary interest under a settlement which satisfies certain conditions.

A reversionary interest is a future interest under a settlement - for example, a right to take the settled property at the time when the settlement comes to an end or

the right to a life interest at some time in the future - and includes in Scotland the fee of property subject to a proper life rent - S47 IHTA 1984.

An example would be a trust under which Andrea had entitlement to income for life (a life interest) with Bill being absolutely entitled to the trust fund on Andrea's death. Here Bill would be entitled to a reversionary interest. Reversionary interests are excluded property (S48 IHTA 1984) unless...

- The reversionary interest has been acquired for a consideration in money or money's worth, whether by the person entitled to it or by a person previously entitled to it; or...

- The interest is expectant on the determination of a lease which is treated for the purposes of IHT as a settlement - broadly, this means a lease which is for a person's life or for a period determinable by reference to a person's death, unless it is a lease granted for full consideration (S43(3) IHTA 1984); or...

- (with minor exceptions) the person who made the settlement, or their spouse or civil partner, is or has been beneficially entitled to the reversionary interest.

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