

Potentially exempt transfers

Synopsis: The tax treatment of potentially exempt transfers.

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Position from 22 March 2006

Paragraph 9 of Schedule 20 Finance Act 2006 amended section 3A of Inheritance Tax Act 1984 to provide that, with effect from 22 March 2006, and subject to the special rules regarding gifts with reservation of benefit, a potentially exempt transfer (PET) is a transfer made by an individual that constitutes...

- A gift to another individual (this includes a gift to a bare or absolute trust).
- A gift to a disabled trust.
- A gift into a bereaved minor's trust on the coming to an end of an immediate post death interest (IPDI). An IPDI is an interest in possession that is created under a Will or intestacy.

Position from 18 March 1986 to 22 March 2006

PETs were introduced on 18 March 1986 when inheritance tax (IHT) replaced capital transfer tax.

Before 22 March 2006, a PET was a transfer made by an individual after 17 March 1986 to another individual, or a gift into an accumulation and maintenance trust, or a trust for the disabled which would otherwise be chargeable.

There was also a PET where a gift was made by an individual to an interest in possession trust on or after 17 March 1987 – S3A(1) IHTA 1984.

Prior to 22 March 2006, there was a PET if, under an interest in possession trust, a beneficiary entitled to income under a trust, had that entitlement removed during their lifetime.

PETs which do not involve gifts

In certain cases, individuals are treated as making a transfer even though they do not physically make a gift. Prior to 22 March 2006, an example of this would be when, say, a beneficiary entitled to income under a trust, has that entitlement removed during their lifetime. That beneficiary would then be treated as if they had made a PET.

If an individual has made a gift which is subject to reservation of benefit rules and the reservation ceases during the lifetime of the donor, the donor is treated as making a PET at the time the reservation ceases.

Consequences of making a PET

If an individual dies within seven years of making a PET (or within seven years of being treated as making a PET), that PET will then become a chargeable transfer and could be subject to IHT itself and/or cause a greater IHT liability on the deceased's estate.

Example

Alan made a gift of £350,000 to his sister Betty on 1 May 2019.

Alan dies on 1 July 2023. There is no immediate charge at the time the PET is made, but as Alan has died within seven years the PET becomes chargeable.

A PET is not chargeable when made, and it is treated as an exempt transfer unless the donor dies within seven years - S3A(4) IHTA 1984 and S3A(5) IHTA 1984. This means that, unless such a death occurs, no account is taken of the PET, and it is not taken into account in determining the cumulative total for any subsequent chargeable lifetime transfers.

If a PET does become chargeable on a death, it is charged on the value transferred when made, rather than on its value at the date of death. The PET also takes its chronological place for cumulation purposes in relation to earlier and later transfers from the time it is made.

The PET will be charged to IHT at the rate of IHT that applies in the year of death, or (if lower) the year in which the PET was made. If the PET is fully within the nil rate band there will be no tax to pay. Any tax that is due will be payable by the donee of the PET, but based on the donor's seven-year cumulation at the date of death.

Tapering relief may apply on calculating the rate of tax payable on the PET. The rate of tax due on the PET will be reduced on a sliding scale provided that the donor survives for at least three years from the date of the gift. **It is important to note that taper relief reduces the rate of tax payable, it does not reduce the value of the transfer for the purposes of the donor's cumulation.** So, if the value of the gift was covered by the donor's nil rate band, taper relief is not relevant.

Thus, when a PET becomes chargeable on death, not only may there be IHT to pay on the PET itself but the IHT on the remaining estate will also be increased to the extent that the PET has used the nil rate band.

Note that a failed PET will not derive any benefit from the residence nil rate band (RNRB) even if it was a gift of a qualifying residence.

If, when a PET becomes chargeable on death, the property gifted is still owned by the donee and its value has fallen since the gift was made, relief may be available. The relief would also be available if the donee has previously sold the property transferred outright to an unconnected purchaser at arm's length for a lower price than its value at the date of original gift. The relief is not available if the asset transferred is tangible movable property that is a wasting asset, that is, it has a

useful life of less than fifty years. In such circumstances, the donee can elect to pay tax based on the lower value or sale proceeds (Sections 131 and 132 IHTA 1984). The market value of the asset for this purpose may be enhanced or reduced by reference to a difference resulting from a change in circumstances between the time of transfer and death.

PETs and chargeable lifetime transfers

Where possible, in any tax year, chargeable lifetime transfers should be made before PETs. This will ensure that the annual exemption will not be wasted in the event that the donor survives for seven years from making the PET. If the PET is made earlier in the year, it appears that HMRC will treat that amount of the PET that can be offset against any available annual exemption as an exempt transfer and, strangely, such a transfer will not, therefore, benefit from the treatment outlined in S19(3A) IHTA 1984. Some doubt does, however, seem to surround this point.

Further, as most lifetime chargeable lifetime transfers occur as a result of a transfer to a discretionary or other flexible-type trust, making the PET after the chargeable lifetime transfer will ensure that it cannot impact on the calculation of IHT charges under the trust in the event that the donor fails to survive the PET by seven years.

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