

Business relief clawback - why PETs might not always be the most IHT efficient option

Synopsis: The mechanics of business relief clawback and the differences in effect of clawback depending on whether the failed gift was a potentially exempt transfer or chargeable lifetime transfer.

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Where a transferor makes a lifetime gift of business property but fails to survive the gift by seven years, the relief that would otherwise have been available in respect of the failed gift is 'clawed back' unless, broadly, the property still qualifies for relief in the hands of the transferee at that time.

Business relief in respect of lifetime gifts will be clawed back if the transferor dies within seven years of the gift and the transferee no longer owns the qualifying business property at the date of the transferor's death - perhaps because it was sold in the intervening period and not replaced, or because the shares when gifted were unquoted but have since become quoted and the holding is not a controlling holding.

Where business relief is clawed back, the failed gift is treated as if it had not attracted business relief and so will potentially give rise to an inheritance tax (IHT) liability if the gifted amount exceeds the nil rate band. This is the same regardless of whether the gift was a potentially exempt transfer (PET) or a chargeable lifetime transfer (CLT).

However, where business relief is clawed back on a CLT, the settlor's cumulative IHT total (or 'clock') is unaffected meaning that any later CLT and/or the death estate may also get the benefit of all or part of the nil rate band. This is in contrast to the position where relief is clawed back on a PET.

By way of example...

- John makes a gift (PET) of £1m of unquoted shares in a trading company to Jane, his daughter;
- John dies within seven years of his gift and, in the meantime, Jane has sold the unquoted shares and has not replaced them. The relief given at outset is therefore 'clawed back' and the PET therefore becomes chargeable;
- John has made no other gifts (other than to use his annual exemption each year) but has an estate worth £2m which is also being left to Jane;
- The failed PET is subject to IHT as follows: $£1,000,000 - £325,000 = £675,000 \times 40\% = £270,000$ IHT payable (there may be some taper relief depending on how long John survived following the lifetime gift);
- As the failed PET is deemed to have used John's nil rate band, there is no nil rate band available to offset against his estate which will be subject to IHT @ 40%, i.e. $£2,000,000 \times 40\% = £800,000$.

- If, instead, the gift made by John during his lifetime had been made to a discretionary trust, the IHT on the failed gift would have been exactly the same as calculated above, i.e. £270,000. However, for the purposes of calculating IHT on the estate, John's nil rate band is unaffected, so the amount of IHT payable on the estate is less, i.e. £2,000,000 - £325,000 = £1,675,000 x 40% = £670,000.

Comment

Because of the different way that the clawback rules work, it can therefore be more advantageous to make a CLT of property which qualifies for business relief at 100% rather than a PET if there is an intention to sell the business property post-transfer. This will be particularly pertinent if the transferor is elderly and in ill-health and there is doubt over whether they will survive the gift by seven years.

As explained above, where relief is clawed back on a PET, the full value of the PET enters the deceased's cumulative total, but if the failed gift is a CLT the cumulative total remains as it would have been had relief been given. This can preserve the nil rate band for use against a later chargeable transfer or the death estate.

Note also that, where the transferor's 100% relief allowance has been taken into account in a previous CLT but the relief is withdrawn, the 100% relief allowance is not reduced and the full allowance remains available to use against any qualifying business property in the deceased's estate.

020 7183 3931

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