Transfers of value for IHT

Synopsis: Ascertaining whether there has been a transfer of value for IHT and the amount transferred.

Date posted: 11.6.26

Transfers of value

A transfer of value is defined in S3 IHTA 1984 as a disposition made by a person as a result of which the value of their estate is reduced. This means that the measure of a gift for inheritance tax purposes (IHT) is the value of the reduction in the donor's total property rather than the value received by the donee.

"Property" is defined in section 272 IHTA and includes rights and interests of any description. This includes a right to claim property, for example on intestacy, even if that right is not exercised (*Daffodil (Administrator of Daffodil Deceased) v IRC [2002] STC (SCD)224).*

Transfers may be made during lifetime or on death. Lifetime transfers may either be chargeable, exempt or potentially exempt transfers. There is a deemed transfer of the value of the person's entire estate on death. A transfer on death which does not fall into one of the available categories of exemption will be a chargeable transfer.

Grossing up

If the donor bears the tax due on the transfer, the loss to the estate will include the tax, so the net gift to the donee has to be 'grossed up' by the amount of the tax in order to arrive at the 'value transferred'. If the donee bears the tax, the value transferred will not include the tax and so there is no need to gross up.

Potentially exempt transfers are not grossed up because no IHT is chargeable at the time of the gift, and, should the potentially exempt transfer become chargeable as a result of the death of the donor within seven years of making the gift, the primary liability for the tax falls on the donee. Therefore, the amount on which tax is charged depends upon both the total amount of the gift and the reduction in value of the estate it causes and whether the donor or the donee bears the tax.

The question of who bears the tax can be decided by the donor and the donee, although the tax can be recovered from either of them if the one who has undertaken to pay the tax does not do so.

Example

Noah makes a gift of £400,000 into a discretionary trust in June 2026.

If the donee (i.e. the trustees of the discretionary trust) pays the tax, the loss to Noah's estate is £400,000. IHT payable thereon would be £15,000 (20% of the excess of the transfer over the nil rate band of £325,000).

If, however, the tax liability is borne by the donor themselves, the loss to their estate would be £400,000 plus the tax paid by them. The chargeable transfer would therefore be the amount grossed up at the appropriate rate, which after the deduction of tax would leave a net gift of £400,000. The first £325,000 is charged at the nil rate, the balance of £75,000 would be grossed up at 20%, giving a total amount of chargeable transfer of £418,750.

Value of transfer

Normally, the loss to the donor as a result of a transfer of value is the open-market value of the property transferred (plus any IHT which the transferor bears). Certain types of property may be worth more in the hands of the donor than in the hands of the donee, and in such a case it is necessary to value the donor's estate (or the relevant part of it) both before and after the transfer.

This principle of loss to the donor’s estate may be particularly relevant where part of a set is being disposed of separately, or shares in a family business are being gifted.

Example

The donor, David, owns a 51% shareholding in a company valued at £100,000 (a).

He gives a 2% shareholding to his son. The market value of the gifted shares is, say, £2,000 (being a minority shareholding) (b).

Following the gift, the donor loses control of the company resulting in a substantial reduction in the value of his remaining holding. The market value of a 49% shareholding is, say, £49,000 (minority shareholding) (c).

The loss to the donor’s estate = (a) - (c) = £51,000, even though the value of the shares gifted is only £2,000.

In addition, if there is any tax payable on the gift, and the donor is paying the tax, the value of the gift would need to be "grossed up" to take into account the tax paid by him (as this would also reduce his estate).

Sales of property at an undervalue (or overvalue) also come within the scope of IHT, as does a loan or a lease for a fixed period if granted for less than full consideration.

In calculating the loss to the donor’s estate, no account is taken of any capital gains tax or stamp duty payable on the occasion of transfer and borne by the donor. Where the capital gains tax is borne by the donee the value transferred is reduced by that tax for IHT purposes S165 IHTA 1984.

Incidental expenses connected with the transfer (for example the cost of preparation of a deed of gift) incurred by the donor are not taken into account in measuring the loss to the donor. If the donee pays these expenses the value transferred is reduced by the amount of the expenses - S164 IHTA 1984.

Pension transfers by those in ill health

There are a number of situations where pensions can be subject to IHT, notably: contributions, assignments of the death benefits and transfers between schemes.

If any of those occur when the death benefits have a value - usually when the member is in serious ill health - then there can be an IHT issue if the member is aware that they are in serious ill health, and their death occurs within two years.

So, where a person knowing they are in serious ill health, makes a pension transfer and dies within two years, this may result in HMRC taking the view that the individual made a lifetime chargeable transfer for IHT purposes when they made the transfer. HMRC's view is that, during a transfer process, the right to decide who receives death benefits comes back into the estate and that is what is being given away.

In good health, the death benefits have no value, so there is nothing to give away in terms of value for IHT purposes. However, in serious ill health, there could be a transfer of value for IHT purposes, depending on the intent of the transfer and the member's awareness of their ill health.

This will involve quantifying the value of the rights in the pension plan that are given away. To undertake this, it is necessary to value the rights of the death benefits at the date of transfer and deduct the value of any pension rights that are retained by the pension scheme member. In this respect, the position on valuing the rights that the individual was entitled to can differ according to the age at which the individual dies and the options then available under the pension plan they belonged to.

Note that, from 2027/28, most unused pension funds will be included in the value of the estate for IHT purposes.

Dispositions which are not transfers of value

Dispositions which are not intended to confer a gratuitous benefit are, in general, outside the scope of IHT. A genuine sale at a price which later turns out to have been unintentionally too high or too low does not give rise to a tax liability, provided that the transaction either was at arm's length between unconnected persons, or, if they were "connected persons", was one which unconnected persons might be expected to make - S10 IHTA 1984. A sale of unquoted shares and debentures is outside the scope of the tax only if the price is such as might be expected to have been freely negotiated. 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. The definition of "connected persons" can be found in S270 IHTA 1984 and the Taxation of Chargeable Gains Act 1992 S 286.

A transaction which is made on “arm’s length” terms may be within the scope of the tax if it is intended to confer a gratuitous benefit on a person who is not a party to the transaction, or involves the purchase of an interest in settled property.

Omission to exercise a right

A person who omits to exercise a right may be treated as having made a transfer of value even though no disposition has been made - S3(3) IHTA 1984. For example, if Alan has an option to purchase property from Bill at less than the open-market value and fails to exercise that option, there will be a transfer of value at the latest time when the option is exercisable. A transfer of value is not treated as having been made if it can be shown that the omission to exercise the right was not deliberate. There will also be no liability to IHT if an omission, though deliberate, is not intended to confer a gratuitous benefit on anyone and it can be shown that the “arm’s length” test is satisfied.

Timing of the transfer

A voluntary agreement to make future payments, such as a deed of covenant, does not give rise to a transfer of value when the deed is entered into. Although entering into a deed of covenant constitutes a disposition, that event on its own does not reduce the value of the donor's estate since the liability to make future payments under the deed is taken into account only so far as it is incurred for consideration in money or money’s worth - S5(5) IHTA 1984. There will be a transfer of value only when a payment due under the deed is made.

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