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Gift of a lifetime

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Emily Grosvenor-Taylor assesses the state of lifetime gifts and failed potentially exempt transfers in the UK

Key points

What is the issue?

Her Majesty's Revenue and Customs (HMRC) has recently released figures that show inheritance tax (IHT) payable as a result of failed lifetime gifts has increased year-on-year between 2015/16 and 2017/18 to GBP488 million.

What does this mean for me?

To some practitioners, this figure may not come as a great surprise, given the complexities of the IHT regime and an increasing number of IHT returns being investigated by HMRC, particularly for high-value estates.

What can I take away?

The various reliefs and exemptions available within the IHT regime and some of the common traps to be aware of when advising clients about lifetime gifts.

During the global pandemic, advisors may have seen an increase in clients who wish to make gifts, perhaps to support family members who have been affected by the current situation or as part of their wider succession planning.

Failed PETs and the seven-year rule

IHT should be considered when a person makes a gift during their lifetime as well as when they die. The general rule is that a gift will be exempt from IHT provided the person making the gift survives seven years from the date of the gift. A lifetime gift is therefore known as a potentially exempt transfer (PET). When a PET fails and becomes subject to IHT, the primary liability for the payment of the tax due falls on the recipient of the gift, with the personal representatives having secondary liability if the tax is not paid by the end of the twelfth month after the death.

Lifetime gifting

Every person has a nil-rate band (NRB) of GBP325,000. This means that the first GBP325,000 of a person's estate is not subject to IHT. If an individual makes a failed PET that is not subject to any exemptions, then it will 'eat into' the NRB and reduce it proportionately. To make matters more complicated, any chargeable lifetime transfers (i.e. gifts into trust) in the seven years prior to making the PET should also be taken into account as this will affect the NRB available. Once the NRB is exhausted then an IHT charge will arise on any further failed PETs that exceed the NRB at death. If a failed PET is made more than three years, but less than seven years before death, then taper relief can reduce the IHT payable on a sliding scale from 32 per cent to as low as 8 per cent if the gift was made 6–7 years before the person died.

The gift with reservation trap

A trap that can often create an IHT issue is a gift with reservation of benefit. A common example of this would be a parent who decides to gift their home to their child, who lives elsewhere, in order to start the 'seven-year clock' running. They might, however, decide to continue living in the property, so reserving a benefit in the asset. A gift with reservation will mean that the property remains in the parent's estate for IHT even if they survive for seven years. Further, there may also be a capital gains tax (CGT) charge when the gift is made. In order to release the reservation, the parent could pay a market rent to live in the property (at which point the gift will be a PET), however, this is not always an attractive option, particularly if the property is of high value.

Using exemptions

For some high-net-worth (HNW) clients, it can be relatively easy to exhaust the NRB through lifetime gifts. These clients should be made aware of the availability of other exemptions or reliefs. International clients should be made aware that IHT will usually be chargeable on UK-*situs* assets, which includes UK bank accounts and cash. Any failed PETs made from a UK bank account that become chargeable will need to be reported to HMRC, even if the client is not UK-resident.

Every person has an annual gifting allowance of GBP3,000 per tax year, which is free of IHT and does not reduce their NRB. This can be carried forward from the previous tax year if not used. An individual can make small gifts of up to GBP250 per person, and they can also make gifts 'in consideration of marriage' of up to GBP1,000 per person. This increases to GBP2,500 for a grandchild or great-grandchild and GBP5,000 for a child. The gift must be made before the wedding and the wedding must take place.

A person can also make regular gifts out of excess income. If a client has surplus income without changing their standard of living or having to use capital, then there will be an immediate exemption to IHT. The client should document this to show that they do indeed have excess income and intend to establish a regular pattern of gifting. They should also keep accurate records of the gifts made. This exemption is particularly useful for those clients with high levels of income by virtue of their salary or pension as there is no limit. However, it is always important to ensure the funds do indeed represent income (and not capital). Record keeping is key to ensure correct reporting to HMRC.

HNW clients in particular may well support a number of dependant family members. There is a further category of transfer that is outside the scope of IHT altogether by virtue of s.11 of the *Inheritance Tax Act 1984* (the Act). Any lifetime payment or transfer made by one registered legal partner to support the other partner or a child of either of them, or to support a dependent relative of the donor, is disregarded for IHT. This can cover any money spent on the maintenance of a child up to the tax year in which they turn 18 or the tax year in which they cease full-time education (if later). Importantly, these payments can be income or capital in nature. An example of when this rule was used was in the case of *HMRC* v *R McKelvey,*[1] where a daughter with a terminal illness gave two houses worth GBP169,000 to her mother, whom she supported, so that they could be sold to cover her mother's nursing home fees.

HMRC viewed the gifts as failed PETs and argued they should be taken into account when calculating the IHT due on the daughter's estate, but the Special Commissioner disagreed.[2] The tribunal considered what constituted 'reasonable provision' under s.11 of the Act and decided this amounted to GBP140,500. Therefore, only the remainder of GBP28,500 was treated as a failed PET. It is always worth exploring this exemption further with clients when discussing their succession planning so that accurate records can be kept if any future claim for this is made.

Further planning options

In some cases, it might be worth making a PET even if the person is not expected to survive seven years, because the PET's value that then becomes taxable is the value at the date of the gift; it does not need to be rebased at death. Therefore, if an asset is expected to appreciate in value (for example, artwork), it may still be worthwhile making such a gift even if the PET fails. Conversely, 'fall in value relief' is available where the asset has fallen in value following the gift to the recipient. In this case, the recipient may elect, under s.131 of the Act, to replace the value at the date of gift with the lower value at death.

Gifts between registered legal partners are also exempt from IHT and a client might consider making gifts to a younger spouse. The spouse can then make further lifetime gifts if it is more likely that they will survive for seven years.

A client might also consider converting assets into relievable property. For example, a relative might need an urgent cash injection for their company. Rather than making an outright gift to the relative (which would be a PET), the client could instead purchase shares in the company. If business property relief (BPR) is available, they only need to survive two years to obtain the relief to take the value of the shares outside their estate.

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[1] [2008] UK SPC 694
[2] The Special Commissioners are a tribunal with full-time members appointed by the Lord Chancellor following consultations with the Lord Advocate and may be barristers or solicitors.

Concluding thoughts

It is always worth considering the full range of IHT reliefs and exemptions for a client when advising on their succession planning. There may be a number of options available to them that can be implemented without the need for complex structuring. Clear record keeping and accurate documentation during the client's lifetime is vital. Without this, possible reliefs could be lost or if claimed without sufficient evidence, there may be the risk of further enquiry from HMRC.

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