

AF1 Inheritance Tax (IHT) 2022/2023

Part 1 Outline and Lifetime Transfers

The next tax to consider is Inheritance Tax (IHT). The milestones for this part are to understand:

- What IHT seeks to tax
- The three types of lifetime transfer.
- How to calculate the immediate tax liability on a CLT

Outline

Inheritance Tax (IHT) seeks to tax transfers of property from one individual to another person, a trust or an organisation. IHT is often considered as a “death tax” but it also taxes gifts made both in life and on death. This part will only be concerned with lifetime transfers.

To come under the scope of the tax, a lifetime transfer must be a **gift**. This means the transfer reduces the donor’s wealth. The sale of an asset or a loan does not reduce the donor’s wealth so no IHT is due. IHT will always seek to tax the reduction in the donor’s wealth rather than the increase in the wealth of the recipient.

Natalie has £100,000 in the bank and gives her sister £10,000. Natalie’s assets have fallen to £90,000 and the gift is a transfer for IHT purposes.

If Natalie had lent her sister £10,000 her assets are still £100,000 as she expects the money to be repaid. A loan is not a transfer for IHT purposes

Lifetime Transfers

These will fall into one of three categories.

- **Exempt transfers:** no tax will ever be payable
- **Potentially Exempt Transfer (PET):** no tax is payable when the gift is made. It will become exempt if the donor is alive seven years after making the gift.
- **Chargeable Lifetime Transfer (CLT):** tax may be payable when the gift is made. They will also become exempt if the donor survives seven years.

Exempt Transfers

These are:

- Transfers between legal spouses and civil partners.
- Gifts to Charities

- Gifts to qualifying political parties (at least two members in the Commons or 1 member provided the party secured 150,000 votes from the whole electorate)
- Gifts for national purposes e.g. museums, universities
- Gifts of Land to Housing associations

They are all unlimited but the position on spousal transfer is tempered by the fact that the receiving spouse must be domiciled in the UK. If the spouse receiving the transfer is non-UK domicile, the limit is £325,000 and anything above this it would be considered a PET. This will be covered in more detail in the residency and domicile section.

There is also a general exemption on what HMRC describe as **disposals**. These are transfers of capital to financially maintain or care for:

- spouse or former spouse
- the donor's children
- other people's children
- dependant relatives.

The exemption to maintain children will normally cease when the child reaches 18 but can be extended if they are in full time education or training.

A parent transfers £10,000 a year to their daughter whilst she is at university. This would be considered a disposal and outside the scope of IHT

In addition to these, HMRC gives individuals further exemptions. These are:

The annual exemption

This is £3,000 per tax year. If all or part of it wasn't used in the previous year it can be carried forward to the current year. This means if no gifts were made in the previous tax year it is possible to gift £6,000 as a totally exempt transfer in the current year.

The gift can be split between different recipients.

- Greg makes a £3,000 gift to his son. This is exempt
- Shula gives her two children £1,500 each. Both are exempt
- Pat gives one of her grandchildren £500, £1,000 to another and £1,500 to a third. They would all be exempt

In practice, it is normally deducted from a PET or CLT. If you see the phrase, "and has made no other gifts" in the question, you should deduct £6,000 from the amount of the gift.

Any unused relief from the previous year is carried forward after the current year's annual exemption has been used.

Paula made the following lifetime gifts to her children:

March 1 2019	£1,600	Exempt, can carry forward £1,400
June 2 2019	£2,200	Exempt but can only carry forward £800
July 3 2020	£5,000	£3,800 is exempt (£3,000 +£800)

If more than one gift is made on different dates, they are dealt with in date order.

Tom gave his daughter £5,000 on 1 July 2020 and £5,000 to his son on 1 August 2020.

Assuming no previous gifts had been made, the gift to the daughter would be exempt (£3,000 + £2,000 carried forward from previous year)

Only £1,000 of the gift to the son would be exempt using the remaining carried forward amount of £1,000

If gifts are made on the same day the annual exemption is apportioned between them.

Tamil gives £8,000 to Jack and £4,000 to Jill on the same date. The annual exemption is apportioned as follows:

Jack. $£8,000/£12,000 \times £3,000 = £2,000$ exempt

Jill. $£4,000/£12,000 \times £3,000 = £1,000$ exempt

Gifts made from a joint bank account are usually considered to be split 50/50 from each account holder

The small gifts exemption

An individual can make unlimited amount gifts of £250 or less to as many recipients as he or she chooses. It cannot be combined with the annual exemption. Pay someone £251 and it would be set against the annual exemption if this was available.

Gifts in consideration of marriage

These are gifts to the bride and groom on their marriage. The figures are:

Parents	£5,000
Grandparents	£2,500
Anyone else	£1,000

The bride and groom can each make an exempt gift of £2,500. This isn't in the tax tables! It is slightly academic since once they are married all gifts to each other are exempt.

These are in addition to other exemptions.

Mr & Mrs Jones' daughter Emma is getting married. They have not made any previous gifts so each could give her £11,000 which would be an exempt gift. £6,000 using two year's annual exemption and the £5,000 wedding exemption

All these exemptions were set in the early 1980's and have never been increased. Inflation has reduced their value so the next class of gift has become much more significant.

Gifts out of normal expenditure

IHT is a tax on the transfer of capital, not on the payment of income Therefore gifts out of income are outside the scope of IHT provided they meet the following criteria.

- They are regular
- They are made from earned or investment income rather than capital.
- It leaves the donor with enough income to maintain their usual standard of living.

Care needs to be taken in ensuring that the gifts really come from income.

- Someone who won £1 million on the lottery and transferred £20,000 a month for two years to their unmarried partner would have difficulty claiming that this was from income.
- Withdrawals from an Insurance Bond using the 5% allowance would also be considered to come from capital.
- The capital element of a purchase life annuity would not be classed as income but the interest element would.

The amount gifted can also be varied. It doesn't need to be the same every month.

Potentially Exempt Transfer

A PET is a transfer that is not exempt and is made to:

- an individual
- a bare/absolute trust.

As noted in the previous section the annual exemption is normally deducted from a PET. If Jack makes a gift of £100,000 to his son, the value of the PET will be £94,000. This is of course subject to him having this and last year's annual exemption available.

No tax is payable when the PET is made and will become exempt if the donor is alive seven years later. If they were to die within seven years it becomes chargeable.

Chargeable Lifetime Transfers

All transfers that are neither exempt or a PET are Chargeable Lifetime Transfers. A transfer to both an Interest in Possession or Discretionary Trust is a CLT.

Unlike a PET tax may be payable on a CLT when the gift is made. This occurs once the total of CLTs in a 7 year period exceeds the current Nil Rate Band (NRB)

Tony has never made any CLTs. He sets up a Discretionary Trust with an initial gift of £100,000. (For simplicity the use of the annual exemption that could have reduced the gift by £6,000 will be ignored). Although it's a CLT, no tax is payable as it is below the NRB of £325,000.

Suzanne has also never made a CLT and pays £525,000 into an Interest in Possession Trust. This is £200,000 more than the NRB so there is an immediate tax liability.

The rate is half the full rate, i.e. 20% so the tax due is $£200,000 \times 20\% = £40,000$.

The next question is who pays it? The liability falls on the trustees so £40,000 must come from trust funds which means that although Suzanne gifted £525,000 the trust ends up with only £485,000.

Suzanne, the donor, can elect to pay the tax but as IHT taxes the reduction in the donor's wealth, the gift will now not be the £525,000 gift but the gift **plus** the tax. HMRC will therefore seek to tax the tax that Suzanne has paid!

The way to deal with this is as follows:

- if the recipient pays, charge 20% on the excess over NRB
- if the donor pays, charge 25% on the excess above NRB

This is an acceptable short cut but the full way to do it is as follows:

Gross up the excess over the NRB by dividing it by 0.8.

$£200,000 / 0.8 = £250,000$

$£250,000 @ 20\% = £50,000$ which is the same as multiplying £200,000 by 25%.

If Suzanne pays the tax the total gross gift would be $£325,000 + £250,000 = £575,000$

The next issue occurs when there is more than one CLT. Whenever a CLT is made you must first look back **seven years** from the date of the transfer and see if any other CLT's were made in this period. If this is the case the earlier gift is subtracted from the current NRB and then the current CLT is deducted from this figure to calculate the taxable amount.

Boris made a gift into a Discretionary Trust of £230,000 on 1/12/18. He paid a further £250,000 into it on 1/6/22. (The £3,000 annual exemption will be ignored)

No tax was payable when the first gift was made as it was below the NRB for that year (£325,000)

The second gift is also below the current NRB (£325K) but since the first gift was made within the previous seven years it must be taken into account.

The first gift is deducted from the current NRB (£325,000 less £230,000 = £95,000)
There is now only £95,000 available for the second gift so £155,000 is chargeable (£250,000 less £95,000)

The amount of tax due if the recipient pays is $£155,000 \times 20\% = £31,000$

If Boris wishes to pay the tax the amount due will be $£155,000 \times 25\% = £38,750$

Where the donor pays the tax and the total gift is subject to a lifetime charge because no NRB is available, the gross gift is calculated as follows:

Boris makes a third gift of £200,000 into the trust on 1 December 2022 and elects to pay the tax.

There is no NRB available and the total gift is grossed up. $£200,000/0.8 = £250,000$

The gift is £250,000 rather than £200,000 and the tax payable is: $£250,000 @ 20\% = £40,000$

You should now understand:

- What IHT seeks to tax
- The three types of lifetime transfer tax
- How to calculate the immediate tax liability on a CLT

Sources

<https://www.moneyadvice.service.org.uk/en/articles/gifts-and-exemptions-from-inheritance-tax>

<https://www.pruadviser.co.uk/knowledge-literature/knowledge-library/inheritance-tax-annual-exemption/>

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