INHERITANCE TAX - 2015-01-21 10:39:52

Avoiding an IHT trap with gifts and trusts

When using trusts to pass wealth to your family, you need to know about a special rule that can trigger extra inheritance tax (IHT) where you also make direct gifts. What is it and when can it apply?

Direct gifts

The simple way to reduce your estate for inheritance tax (IHT) purposes is to give away your wealth. As long as you survive seven years from the date of the gift, it won't be liable to IHT as part of your estate. For that reason a gift of this type is called a potentially exempt transfer (PET). However, if you die before seven years have elapsed, the value of the gift affects the IHT payable on your estate.

Example. In 2009 Gill gave her daughter a house worth £240,000. Gill died in June 2014. The gift was a PET but became chargeable to IHT because Gill died within seven years of making it. When working out the IHT, £240,000 of her nil rate band (NRB) (that's the part of an estate on which no IHT is payable), is used by the PET. As the current NRB is £325,000 only £85,000 is left. The value of her estate above that is taxable at 40%.

Indirect gifts - discretionary trust

A trust can be used to make gifts, typically to family members, where you want to keep some control over what you're giving away. For example, you might want to give your son some valuable quoted shares, but you don't trust him not to sell them and blow the money. Instead, the trustees control the money and assets and dole these out to your son when they see fit. You can be a trustee of a trust you set up.

Special IHT rules for trust

A gift made via a trust while you're alive is for IHT purposes called a chargeable lifetime transfer (CLT). The NRB applies to these too. Where a gift to a trust exceeds £325,000 in value, IHT at 20% is payable on the excess. If you die within seven years of making the gift, another 20% IHT is payable. That's pretty straightforward, but it gets trickier where you make a combination of CLTs and PETs.

The 14-year rule

If a CLT is made within the seven years before a PET, and you die within seven years of that, the PET becomes chargeable to IHT, i.e. the seven year rule applies. Plus, the full amount of the CLT must be added to the PET when calculating the IHT. In effect, a CLT made up to 14 years before you die can increase IHT on your estate.

Example continued. Six years and 364 days before Gill gave the house to her daughter she made a gift of £85,000: a CLT to a discretionary trust for her grandson. As it was within seven years of the PET when Gill died it is included in the IHT calculation. The £85,000 CLT plus the PET of £240,000 add up to £325,000 and wipe out Gill's NRB.

Tip 1. Time your gifts carefully. If Gill had waited just another two days before giving the house to her daughter, the CLT would have taken place more than seven years before and could have been ignored. If you've already made a CLT, avoid making a PET within the next seven years.

Tip 2. Make gifts in the most IHT-efficient order. When estate planning consider making gifts that count as PETs before those which count as CLTs. The 14-year rule won't then come into play, that is unless you make another PET after you've made a CLT.

If you make a gift via a trust and within seven years make another, but directly, and then die within seven years of that, both gifts will be taken into account when calculating IHT. This is known as the 14-year rule. To avoid it make the gift to the trust after the direct gift or leave at least seven years between them.
