Inheritance tax and potentially exempt transfers

Aside from the annual exemption and the exemptions for particular gifts (such as those out of income or in consideration of marriage), it is possible to make gifts free of inheritance tax – as long as you survive for at least seven years after the date of the gift. The problem is that none of us knows when we are going to die.

If the estate is not going to exceed the nil rate band (currently set at £325,000 plus the residence nil rate band (currently £125,000), available where the home is left to a direct descendant)), there is no rush to reduce the estate by making gifts. Remember also that the unused portion of the nil rate band and the residence nil rate band can be used by the surviving spouse or civil partner (for example, where the estate is left to the surviving spouse on the first death benefitting from the inter-spouse exemption).

However, where the estate on death is likely to exceed the nil rate band, it can be beneficial from an inheritance tax perspective to make lifetime gifts – and the earlier the better. The rules allow the transferor to make unlimited lifetime gifts free of inheritance tax if he or she survives for seven years.

PETs

A PET is a potentially exempt transfer. PETs are only chargeable if the transferor dies within seven years of making the gift. If the transferor survives at least three years but less than seven from the date of the gift, the IHT payable is reduced on a sliding scale.

A gift to another individual or into a trust is a PET.

No IHT when PET is made

It is assumed at the time at which the gift is made that the transferor will survive seven years and that the gift will remain free of inheritance tax. Consequently, no inheritance tax is payable at the time that the gift is made.

Transferor survives seven years from date of gift

If the transfer survives at least seven years from the date on which the PET was made, it remains completely free of inheritance tax.

Transferor dies within seven years of making the PET

In the event that the transferor does not survive seven years from the date on which the PET was made, the PET is brought into charge for inheritance tax purposes. The value of the PET is cumulated with earlier transfers brought into charge, the death estate and subsequent transfers to work out the inheritance tax payable on the estate.

However, as the nil rate band is applied to earlier transfers before later transfers, it may benefit from the nil rate band, such that the inheritance tax is payable on the death estate or subsequent lifetime transfer.

If the transferor survives less than three years from the date of the PET, IHT is payable in full.

Transferor survives at least 3 years

If the transferor survives at least three years but less than seven from the date of the PET, taper relief is available and the tax payable on the gift is reduced. Gifts made between three and seven years before death are taxed on a sliding scale.

Years between gift and death	Tax paid
Less than 3	40%
3 to 4	32%
4 to 5	24%
5 to 6	16%
6 to 7	8%
7 or more	0%

Planning ahead

While there is no guarantee that the transferor will survive the seven years needed to take a gift out of charge, making lifetime gifts can potentially reduce the inheritance tax bill.