TAX FACTSHEET

THE TAX IMPLICATIONS OF MAKING LIFETIME GIFTS

Giving away wealth and assets to family and friends is a common way to reduce the value of your estate. As a strategy it does, however come with tax consequences which it is important to understand and address. This Tax Factsheet provides an overview of the Inheritance Tax (IHT) and Capital Gains Tax (CGT) provisions which apply to lifetime gifts.

The relevance of domicile

As a starting point in setting out the basic principles, it should be noted that, generally, foreign assets held by a person who is neither domiciled in the UK nor deemed domiciled here are exempt from IHT. They are considered to be 'excluded property'. The word 'generally' is used above because there are exceptions connected to UK residential property. An interest in the share capital of a foreign company or an interest in a foreign partnership are normally 'excluded property', but since 6 April 2017 this is no longer the case to the extent that their value can be attributed to UK residential property. Also, a loan used to acquire, maintain or enhance UK residential property is not exempt, nor is collateral used for such a loan. The IHT exemption for foreign assets ceases to apply to a non-domiciled individual once they have acquired 'deemed domicile' status on being UK resident in at least 15 of the previous 20 tax years (although excluded property status might continue to apply to foreign assets settled on a trust by the individual before deemed domicile status was acquired).

Assets which are exempt from IHT as excluded property can be gifted without a charge to IHT. The rest of this paper deals with IHT on assets which are not exempt as excluded property but are within the scope of the tax.

Transfers which are exempt from IHT

There are a number of transfers which are exempt from IHT, either because they are small, or because they are made for a specific purpose recognised by the

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legislation, or because they are made to a particular type of donee. The appendix at the end of this Tax Factsheet sets out the main exemptions from IHT which apply.

Assets which qualify for a relief from IHT

There are two reliefs which reduce or eliminate the value transferred, where the asset gifted is of a particular type.

Business Property Relief

Many business interests are eligible for Business Property Relief (BPR). The main activities which do not attract relief are those which consist wholly or mainly of dealing in securities, stocks and shares (unless the business is that of 'market maker' in the UK), dealing in land and buildings (unless it is a business of construction or land development) and the making or holding of investments. There is a considerable body of case law on the matter of whether activities such as furnished holiday lets, operating caravan parks and other land-based activities fall foul of the investment business exclusion. The relief given is 100% on an unincorporated business or an interest in a partnership. There is relief at 50% on the value of an asset which a partner in a partnership owns personally but permits to be used in the business of the partnership. Shares in an unquoted (deemed to include AIM-listed companies) company conducting a qualifying business attract relief at 100%, as do securities which either on their own or together with other shares or securities gave the transferor control of the company immediately before the transfer. There is a similar provision for quoted shares and securities which give control over a company, but the relief is 50% in this case. Securities such as loan notes or stock which carry no rights which contribute to control are not eligible for relief.

Generally, it is necessary to hold the asset for a minimum of two years before relief applies, and assets which would otherwise qualify but are the subject of a binding contract for sale are not eligible for BPR.

Agricultural Property Relief

Agricultural Property Relief (APR) reduces for IHT purposes the agricultural value of property and land used for farming activity. To qualify, the property must have been occupied by the transferor for the purposes of agriculture in the two years prior to the transfer, or owned by the transferor in the seven years prior to the transfer and occupied during that period for the purposes of agriculture either by the transferor or a third party. The rate of relief is in many cases 100% but can be 50% in certain limited situations which are beyond the scope of this paper. The farmhouse, its agricultural value (as opposed to residential) and the extent to which it is occupied for the purposes of agriculture is a subject which often proves to be contentious in practice.

Both of the above reliefs are complex, and planning to utilise them requires a detailed understanding of the relevant legislation and case law.

The position with gifts which are not covered by an exemption or relief

If a gift is not covered by an exemption, it will either be a chargeable lifetime transfer (a 'CLT') or it will be a potentially exempt transfer (a 'PET'). Each of these is covered below.

Potentially Exempt Transfers

A PET is a gift from one individual to another individual (in practice often a family member)

or to a special category of trust for the benefit of a person with a disability. No IHT arises at the point when a gift qualifying as a PET is made. Tax only becomes payable if the individual making the gift dies within 7 years of the gift. In the event of death within 7 years of the gift, all lifetime gifts made in the 7 years prior to death are aggregated with the estate of the deceased, and any unused nil rate band (see below) is allocated to the earliest gifts in this period in priority to later gifts. IHT is then computed on the PET and liability to pay the IHT falls in the first instance on the person to whom the gift was made.

The rate of IHT payable on a failed PET is determined by how long the deceased survived after the gift was made. If they survived for less than 3 years, the full rate of IHT (40% after any unused nil rate band) applies. If they survived more than 3 years but less than 4, the rate is reduced by 20%. Survival for 4 years but less than 5 gives rise to a 40% abatement, rising to 60% where the donor survived for 5 years but less than 6, and 80% where the donor lasted for more than 6 years but less than 7. This 'tapering relief' can therefore significantly reduce the IHT payable in practice, and it is possible to obtain bespoke life insurance on the life of the donor providing for gradually reducing cover over this 7 year period.

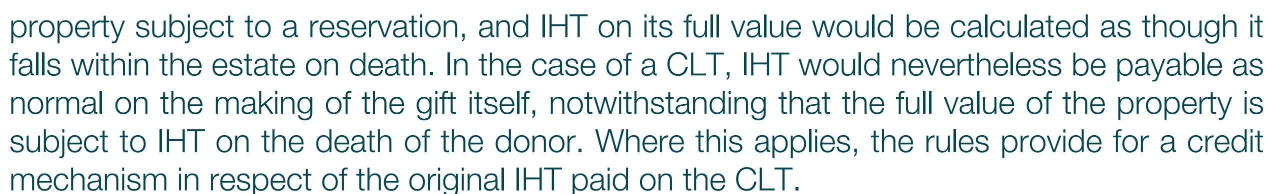
Chargeable Liftetime Transfers

A gift which is not a PET or an exempt transfer is a Chargeable Lifetime Transfer (CLT) on which IHT may be due. The rate of IHT on a CLT is 20%, although the amount charged will depend on whether there is any available nil rate band (£325,000) to allocate to the transfer. This will depend on the value of any other CLTs made in the 7 years prior to the transfer (to which the nil rate band will have been allocated on an 'earliest first' basis). A full nil rate band would be available if there have been no CLTs in the preceding 7 years. The most common situation in which a CLT arises is where a lifetime gift is made to a trust or to a company. Although the initial rate of IHT on a CLT is 20%, applied to the value of the transfer in excess of any nil rate band, this may not be the end of the matter. If the transferor dies within 7 years of the CLT, the rate of IHT on the transfer is increased, with the same rates applying as described above with 'tapering relief' so that the rate of IHT is determined by the number of years which the transferor survived the making of the CLT. The amount of IHT on the CLT may also vary depending on whether the transferor or the transferee is liable to pay the tax, an issue often specified in the deed of gift signed on the transfer. If the transferor pays the IHT, it is necessary to treat the amount of the gift as a net sum and the amount of IHT is ascertained by 'grossing up' the gift.

The Executors of an estate have to consider carefully the gifts made in the 7 years before the donor's death. If the nil rate band was allocated to CLTs in this period, it remains in place and is not retrospectively reallocated to failed PETs made earlier in the seven year period which have now become chargeable.

Gift With Reservation of Benefit anti-avoidance provisions

It was recognised when IHT replaced the old Capital Transfer Tax that introducing a regime for PETs, enabling a transferor to avoid IHT on a transfer of wealth by surviving for 7 years, might encourage abuse. For example, what would prevent a donor from simply transferring ownership of the family home to younger family members, but continuing to live there rent-free? This would provide a way to move significant value out of an estate without inconveniencing the donor. To prevent this from being effective, the IHT legislation includes provisions which render a lifetime gift ineffective unless the property gifted is enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor. The same provisions apply to CLTs where the donor reserves a benefit, such as a transfer of property to a trust of which the donor is a beneficiary. In both instances (of a PET or a CLT), the property gifted is deemed to be



property subject to a reservation, and IHT on its full value would be calculated as though it falls within the estate on death. In the case of a CLT, IHT would nevertheless be payable as normal on the making of the gift itself, notwithstanding that the full value of the property is subject to IHT on the death of the donor. Where this applies, the rules provide for a credit mechanism in respect of the original IHT paid on the CLT.

It is possible that property which is subject to a reservation when gifted subsequently ceases to be subject to a reservation. For example, the family home gifted in the above example would cease to be subject to a reservation if the donor ceased to occupy the property, or commenced to pay a full market rent on the property. When property ceases to be subject to a reservation in this way, the donor is treated at that time as having made a disposition of the property which is deemed to be a PET.

CGT on lifetime gifts

Where the property which is subject to a gift is a chargeable asset for the purposes of CGT, it is also essential to consider any CGT consequences of making a gift. Although normally a gift involves no monetary consideration being given, CGT rules apply which treat a disposal other than at arm's length (such as a gift) as though it had taken place at full market value. In addition to this general principle, the rules then go further and specify that any disposal to a 'connected person' is treated as though it had been made other than at arm's length. A person is 'connected' to an individual if that person is their spouse, or an ancestor, a lineal descendant, or sibling of the individual or of the individual's spouse, or any spouse of such a person. An individual is 'connected' with the trustees of a settlement if the individual or any of the people connected to the individual (as listed above) were settlors of the trust. An individual is 'connected' to a company if it is controlled by the individual or the individual and persons connected to the individual have control of the company. These are the basic provisions most commonly encountered.

The basic rule is that when an asset is gifted, it will be deemed under the above provisions to have been sold at open market value and CGT computed accordingly. There are, however, some important exceptions and reliefs.

Firstly, a gift from one spouse to another, provided that they are living together, is treated as though it had been disposed of for consideration equal to the donor spouse's base cost, so that the asset effectively passes for no gain and no loss. There is also an exemption relating to donations to charity.

Secondly, there are limited situations in which the gain, as computed under the above full market value provisions, can then be held over so as to reduce the donee's base cost (which would otherwise be the full market value). There are two types of holdover relief.

The first type of holdover relief is available where the asset subject to the disposal falls within a particular category of 'business asset', such as shares or securities in an unquoted trading company or in a trading company (or holding company of a trading group) which is the donor's 'personal company' (one in which the donor exercises at least 5% of the voting rights), or an asset used in a trade conducted by the donor or their personal company. An asset which is agricultural property qualifying for APR is also eligible for holdover relief. Although disposals to non-residents are generally not eligible for holdover relief, a relaxation was introduced in 2015 in relation to disposals to and by non-residents of direct or indirect interests in UK land, which are used in a business (such as Furnished Holiday Lets), recognising that from 2015 such assets are subject to CGT in the hands of non-residents as well as resident persons.

The second type of holdover relief applies where the gift gives rise to a CLT for IHT purposes, so that there would (subject to BPR or APR being available) be both IHT and CGT on the same gift unless the capital gain can be held over. Even so, this form of relief is not available where the CLT is a transfer to a trust in which the donor, or the spouse or minor child of the donor, could derive benefit. Although generally a disposal to a non-resident person is not eligible for this type of holdover relief, an exception is made for a direct or indirect interest in UK land (these now being chargeable assets in the hands of a non-resident).

Final observations

A programme of lifetime giving is often the most effective way to reduce an estate and mitigate IHT liabilities on death. It is not, however, a simple process to do this effectively. There are many traps and pitfalls to catch out would-be donors. There are reliefs and exemptions which can aid a lifetime giving strategy, but they have complex conditions to satisfy. Anyone putting together a lifetime estate planning strategy will benefit from the advice of an adviser experienced in this area.

Appendix - Important Exempt Transfers

£3,000 per year, plus previous year's £3,000 if not used

£250 to any one person in any tax year, provided that the aggregate value transferred doesn't exceed £250

Up to £5,000 by a parent in contemplation of the marriage of a child

Up to £2,500 by a party to the marriage to the other, or by a grandparent or great grandparent etc. of a party to the marriage

Up to £1,000 by anyone else on a gift in contemplation of marriage

Exemption for transfers between spouses (unless recipient is non-domiciled *)

Exemption for dispositions not intended to confer gratuitous benefit

Dispositions for maintenance of family

Exemption for normal expenditure out of income**

Gifts to charity

Gifts to political parties (as defined)

Gifts to museums and art galleries in the UK

**If the donee spouse is foreign domiciled and not deemed domiciled, the exemption for transfers between spouses is replaced by a capped exemption of £325,000. The donee spouse can, however, make an election to be treated as UK domiciled for all IHT purposes in which case the full exemption for inter-spousal transfers applies*

***The exemption in respect of transfers which are 'normal expenditure out of income' is particularly useful for those with high levels of income who can give sums away regularly without affecting their lifestyle. It is essential that the gifts out of income are 'normal' and conform to a pattern*

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