

Potentially Exempt Transfers

Key Learning Points

1. Recognising a PET
2. Effect of a failed PET
3. Legislation changes
4. Beware of CGT

1. Recognising a PET?

A PET is a transfer of value (a gift), which:

- is made by an individual during his/her lifetime
- Would otherwise be a chargeable transfer, and
- is a gift to another individual or the limited specified trusts mentioned below

If the Donor survives for seven years from the date of the transfer then the transfer is fully exempt from IHT as long of the donor did not retain any benefit from the gift. A PET does not impact on the available nil rate band of the Donor as it is not immediately chargeable, like a Chargeable Lifetime Transfer is.

It is in essence a 'wait and see' gift which will potentially be taxable, subject to the Donor passing away within 7 years of making it.

The estate of the beneficiary of the PET is of course immediately increased by the value of the PET and thus for a period of 7 years, the gifted amount is assessable on two different estates, the Donor and the beneficiary.

The term 'individual' includes the beneficiary of a qualifying interest in possession (QIIP). This is because such a beneficiary is treated for IHT purposes as beneficially entitled to the underlying trust property.

Consequently, in addition to an outright gift from an individual, a PET is made when a QIIP comes to an end and the trust property passes to a remainderman.

Any exemptions available are notionally deducted from the amount of the transfer in order to determine the value of the PET. ie the annual exemption, the marriage exemption and the exemption for recipient-spouses/civil partners who are not domiciled in the UK.

It is important to note that exemptions are allocated to transfers made in chronological order.

So where a donor makes a PET before making a CLT in any given tax year, the annual exemption/s available in that year will be allocated to the PET meaning the lifetime tax on the chargeable transfer will be higher than it would have been, had it been made before the PET.

Thus the annual exemption/s is potentially wasted.

The following events are deemed to be PETs for the purposes of IHT:

- i. where property ceases to be subject to a reservation of benefit
- ii. where money or money's worth is applied to repay or reduce certain debts

2. Effect of a failed PET?

If the donor dies within seven years of the transfer, then the PET fails and IHT becomes chargeable.

It is then treated as a chargeable lifetime transfer for the purposes of calculating any tax due on death under the additional charge, and will enter into the cumulative total, i.e. use the available nil rate band for that purpose.

Thus the record of transfers, both original CLTs and failed PETs, has to be revised and re-ordered to calculate the tax on death.

If there's Inheritance Tax to pay, it's charged at 40% on gifts given in the 3 years before you die. Gifts made 3 to 7 years before your death are taxed on a sliding scale known as 'taper relief'.

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%

The practical application is not as straightforward as often thought. When considering a lifetime gift made less than 7 years ago, you must first apply any other allowances or exemptions that are available such as the annual exemption.

The remaining value of the gift, after the deduction of exemptions will be added back into your estate when calculating the IHT due on your death. In practice, the value of this gift will use up some or all of your Nil Rate Band (NRB). IHT will not be due on the value of the gift itself unless there was no NRB available due to earlier lifetime gifting or if the gift itself was over the NRB.

It is important to note that tapering does not apply to the gift itself but instead only to the tax charged on the gift. Thus tapering will only occur if you have gifted more than £325,000 (the NRB) to non-exempt beneficiaries in the 7 years prior to your death.

In short, provided the gifts were all within the NRB, there will be no taper relief available, despite the gift potentially being 6 years ago.

It is not necessary to inform HMRC at the time the donor makes a transfer that is classified as a PET.

However, should the PET fail so that the transfer becomes a chargeable transfer, then HMRC must be notified, either using form IHT100 or more usually on form IHT400 submitted by the personal representatives after a death.

The recipient of the gift is primarily liable for the tax due on a failed PET.

If tax remains unpaid 12 months after the transferor's death, the personal representatives have a secondary liability.

Life assurance policies to cover the tax risk of death within 7 years of a gift can be taken out where needed.

3. The 14 year rule...

You should also note that there is a 14 year rule to consider and this applies particularly to failed PET's. In essence, if a PET fails, then you must look 7 years prior to the failed PET to calculate whether there is any further tax due.

In practice, this looks as follows:

1. John gifts £325,000 into a discretionary trust in 2010 (a Chargeable Lifetime Transfer)
2. John later gifts £325,000 to his son absolutely in 2016 (a Potentially Exempt Transfer)
3. John dies in 2021

Looking at this, you might assume that as the CLT which was made in 2010 was completed more than 7 years ago (actually 11!) that it would be outside of the estate for IHT purposes in the event of John's passing away.

However, due to the fact that there was a PET made in 2016, within 7 years of the CLT and within 7 years of death, both transfers are brought back into the equation for IHT purposes.

The £325,000 PET would therefore be subject to IHT at 40%, however taper relief would be available as per the above.

You should note here that if the transfers were made in reverse, this IHT impact would not have happened, the 14 year rule only applies to a failed PET.

So if there were no PET's made in the 7 years prior to John's death, but just the CLT because we've reversed the gifts, then there would not have been any IHT to pay as a result of the death of John, on the lifetime gifts made.

4. Legislation changes

In general, a gift needs to be made to an individual in order to be a PET. However, there are certain exceptions where gifts can be made into trust and still be deemed a PET. Prior to 22 March 2006, lifetime gifts to an interest in possession trust, an accumulation and maintenance trust or a disabled person's trust were also treated as PETs meaning you could gift unlimited amounts into a trust.

Post 22 March 2006 only lifetime transfers to a disabled person's trust or a bereaved minor's trust or the ending of an immediate post-death interest (IPDI) in favour of an individual qualify as PETs along with individuals.

Thus gifts into trusts are potentially exempt if they become subject to a qualifying interest in possession but it is no longer possible to create a lifetime qualifying IIP with the exception of a Vulnerable Person's Trust. For more information on this, see our Tech Sheet on Vulnerable beneficiary trusts.

5. Beware of CGT

While a gift may be potentially exempt from IHT, it must always be considered that the gift will be treated as a disposal at the market value of the asset at the time of the gift and so could be liable to CGT.

In short, CGT is payable on the disposal and not necessarily the sale of an asset, meaning you may need to pay a CGT bill when you will not be receiving any funds in return.

Holdover relief can on some occasions be applied for to allow the CGT to be deferred, but there are a limited number of situations whereby this applies.

Holdover relief is only available for gifts of business/agricultural assets, unlisted share, interests in UK land to or from non-UK residents, chargeable transfers for IHT purposes or certain types of gifts that are specifically exempted from IHT.

As a PET is not a chargeable transfer for IHT purposes, unless it satisfies one of the other categories mentioned, Holdover relief will not be possible.

Summary

1. PET is a lifetime transfer to an individual where no IHT is payable if the donor survives 7 years from date of gift.
2. The value of the gift will be immediately in the donee's estate and will remain in the donor's estate for 7 years after which point it will be completely out of the donor's estate.
3. If the donor dies within 7 years of the gift, the transfer is no longer exempt and IHT becomes payable. Taper relief applies for gifts made between 3-7 years before death.
4. Since 22 March 2006 only transfers into trusts that are deemed PETs are to disabled person's trust or a bereaved minor's trust
5. Most PETs do not qualify for Holdover relief from CGT unless they are business assets.