

IHT and the 14-year rule (Lecture P1430 – 19.21 minutes)

With all the talk in recent months about the possible abolition of IHT (mainly orchestrated by the press), there is one principle of the tax which flies largely under the radar and which is, in consequence, not widely appreciated.

Most of us are familiar with the seven-year rule in relation to lifetime gifts and IHT planning, but that part of the legislation does not tell the whole story.

It is crucially important for tax advisers and financial planners to understand the significance of what is sometimes termed 'the 14-year rule'.

Gifts made more than seven years before the donor's death have always been exempt from IHT (S3A(4) IHTA 1984).

However, the impact of the 14-year rule is that gifts which were made more than seven years before the donor's death and therefore fall outside the deceased's IHT computation can affect the amount of tax payable on later gifts which are still within the seven-year window.

The importance of this facet of the IHT code was neatly summarised by these words from a financial planning commentator:

'For advisers, understanding how the 14-year rule works will help clients with the timing and value of gifts to achieve better IHT outcomes. In some cases, it could mean that clients may . . . wish to cap the amount they gift or defer gifting until a later date. But, in others, there may be scope safely to make larger gifts.'

Efficient lifetime giving is a core element of IHT planning. Unfortunately, when tax advisers recommend making lifetime gifts, they are often not faced with a clean slate when it comes to the gifting record.

When giving consists of only making chargeable lifetime transfers into discretionary or life interest trusts, most taxpayers will want to keep the seven-year cumulative total of their chargeable lifetime transfers below the nil rate band (currently £325,000). If they exceed this figure, there will be an immediate IHT charge of 20% on the excess.

Where clients wish to be more generous than this, they may consider making outright gifts which qualify as potentially exempt transfers (PETs). As mentioned above, PETs never attract an IHT charge during the donor's lifetime and will be exempt once he has survived the requisite seven years. Of course, if the donor dies within seven years of making the gift, the PET becomes a chargeable transfer and this will usually impact on the amount of IHT which may then be payable. But how is this to be calculated?

In order to answer this question, it is necessary to determine how IHT is computed following a death. There are in fact two computations, one for the tax on the estate itself and the other for the tax on gifts which fall within the last seven years of the donor's life.

Broadly speaking, the tax on the deceased's estate is based on the IHT value of the estate less any available nil rate band. This latter figure will include:

- (i) the deceased's residence nil rate band (if available);

- (ii) any transferable nil rate band from a pre-deceased spouse or civil partner; and
- (iii) any transferable residence nil rate band from a pre-deceased spouse or civil partner.

The available nil rate band is reduced by all the chargeable transfers (including failed PETs) which were made in the seven years before death. Any gifts which pre-date this seven-year period are ignored for this purpose – the 14-year rule has no relevance here.

In this context, it is important to remember that the chargeable lifetime transfers and failed PETs from the last seven years **never** reduce the residence nil rate band (including any transferable residence nil rate band).

It is also necessary to look at each lifetime transfer in strict chronological sequence, going back over the seven years before death. This includes PETs which have now become chargeable. HMRC are seeking to assess the tax which would have been due at the time when they were made (but using current rates). This will in turn pick up chargeable transfers in the seven years prior to the gift in question which of course means that chargeable transfers made up to 14 years before the taxpayer's death can determine the IHT payable.

That, in a nutshell, is the 14-year rule. The IHT position is illustrated in the mini-case study below.

Illustration

Edward, a widower, is the father of Poppy and Hector. He is also the grandfather of five grandchildren. Edward's wife utilised her nil rate band and her residence nil rate band in full when she died.

Edward's gifting history is as follows:

Year 1 £300,000 to a discretionary trust for the grandchildren

Year 4 £100,000 gift to Poppy

Year 7 £50,000 gift to Hector

Year 9 £75,000 to a discretionary trust for the grandchildren

Year 13 Edward dies, leaving an estate of £800,000 (including a family home value at £420,000) – his whole estate is split between his two children, Poppy and Hector.

Let it be assumed that the lifetime gifts and Edward's death occur on the same date in the relevant calendar year and that Edward's annual IHT allowance of £3,000 has been fully utilised.

Start with the calculation of the IHT on Edward's death estate.

The transfers in Year 7 (failed PET of £50,000 to Hector) and Year 9 (chargeable lifetime transfer of £75,000 to the grandchildren's discretionary trust)) have to be included as part of the IHT computation on Edward's death.

This uses up $£50,000 + £75,000 = £125,000$ of Edward's nil rate band, leaving an available amount of $£325,000 - £125,000 = £200,000$.

Edward's lifetime transfers do **not** reduce his residence nil rate band.

His available nil rate band is £200,000 and his residence nil rate band (given that his residence passes to his two children) is £175,000.

As a result, the IHT on Edward's death estate is based on $£800,000 - £200,000 - £175,000 = £425,000$, i.e. $40\% \times £425,000 = £170,000$.

We then have to calculate the IHT on the lifetime transfers made in the seven years before Edward's death.

The PET of £50,000 to Hector in Year 7 has become chargeable. It is necessary to include any chargeable transfers occurring in the seven years prior to this gift in order to calculate the IHT due. This will include the chargeable lifetime transfer of £300,000 made to the grandchildren's discretionary trust in Year 1, but not the gift of £100,000 to Poppy in Year 4 (given that this has become exempt because it was made more than seven years before Edward's death).

Because the $£300,000 + £50,000 = £350,000$ exceeds the current nil rate band by £25,000, this means that there will be an IHT liability of $40\% \times £25,000 = £10,000$. However, this sum will be further reduced by IHT taper relief of 60% since Edward died exactly six years after the date of the gift to Hector, leaving a tax bill of £4,000 for Hector to pay.

Next it is necessary to assess the chargeable lifetime transfer of £75,000 in Year 9. Looking back over the previous seven years, we only need to include the failed Year 7 PET to Hector. The PET to Poppy in Year 4 is exempt and the Year 1 chargeable lifetime transfer to the grandchildren's discretionary trust was made more than seven years previously. The total of the two chargeable transfers is $£50,000 + £75,000 = £125,000$, i.e. well under the nil rate band of £325,000. Therefore, the trustees of the Year 9 discretionary trust transfer have no tax to pay.

As mentioned in above, the transfers made in Year 4 and Year 1 do not need to be revisited in view of the fact that they were made more than seven years before Edward's death.

The IHT payable on Edward's lifetime gifts – following his death – is £4,000.

If the gift to Hector in Year 7 had been limited to £25,000, there would have been no tax on this transfer, but there would then have been an extra £25,000 in Edward's estate. Ignoring any capital growth, this would have resulted in an additional tax liability of £10,000.

However, if the gift to Hector had been delayed by one year, this transaction would have avoided tax altogether by ensuring that there was a gap of seven years between the date of the gift to Hector and the original gift of £300,000 into the discretionary trust. Of course, this must be balanced against the likelihood of the client surviving his gifts by seven years, i.e. the earlier that a gift is made, the sooner it will fall outside the estate altogether.

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