

The problem of PETs (Lecture P1459 – 20.34 minutes)

As a result of speculation regarding the forthcoming budget on 30 October, a considerable number of clients are considering making transfers to their children or other relatives in case the inheritance rules (IHT) are tightened. This article shows some of the perils in doing this and the requirement for proper consideration before hasty and potentially irreversible action is taken.

Background

By way of background, the concept of potentially exempt transfers (PETs) has been around since the 1890s when Estate Duty was introduced. The principle then was that if an individual survived 5 years after making gifts, then those gifts would not be subject to Estate Duty. This rule applied until the introduction of Capital Transfer Tax in 1975 (CTT). CTT attempted to tax all transfers beyond an exempt band. CTT lasted until 1986 when tax on some lifetime transfers were lifted, and the tax was renamed Inheritance Tax.

The new regime of potentially exempt transfers extended the period under which transfers could be subject to IHT to 7 years before death. However, it did also introduce a taper arrangement whereby there was a progressively greater reduction in tax if the individual survived more than 3 years after the gift.

Also, a number of anti-avoidance rules that had been in Estate Duty but not required for CTT were reintroduced with IHT. These most notably included the gift with reservation clause, where broadly if one gives away an asset and continues to enjoy it, it remains within one's estate when one dies.

Potentially Exempt Transfers look like a relatively easy way of avoiding inheritance tax but there are a number of considerations which should give people pause for thought. First of all, there is the non-tax consideration that once the asset has been given away, they are no longer available for the individual's use. They may remain within the family but if the planning is to be effective, the individual can gain no benefit from them. This has a number of consequences, both tax and non-tax.

However, perhaps the non-tax consideration is the most important. Given that, life expectancy has been growing, particularly for the sort of people who have IHT issues, individuals should be aware that they may need considerably more money than they anticipated. This could be to fulfil whatever goals they have in retirement (the bucket list of travel places), but also the care fees which may become necessary. A quick review of care fee costs would show that one could get through a substantial amount of money very quickly indeed.

Family relationships are often fluid and therefore relying on family may not be wise even if the relationship may be good at the moment. Even if the relationship may remain good, one needs to take into account that the funds or property given to relatives may be beyond their ability to return even if circumstances change.

Moving on to the tax points, one needs to be aware that PETs could create unequal circumstances between those receiving funds. For example, if one had 3 children and one was to give Richard and James money but leave Alex to inherit when one died. Richard and James' gifts may be free of IHT under the current rules, but they would affect the amount of tax that Alex would suffer on his legacy as any PETs within 7 years of death would use up the nil-rate band. So, if Richard and James received £162.5k each, they would pay no IHT but if you then left Alex another £162.5k in your will and died within seven years of the earlier gifts, he would have IHT of £65k to pay.

You could therefore have been said to have dealt with the children equally, but some more equally than others!

Capital Gains Tax

You also need to consider that a taxpayer who gives away assets, standing at a gain, may have an immediate charge to Capital Gains Tax on the basis that they have made a disposal of an asset standing at a gain which is a chargeable asset. This could create a double-tax charge as if the taxpayer dies within 7 years there will be IHT on the failed PET, but no credit given for the CGT paid.

Some taxpayers may look to hedge their bets by giving amounts conditionally or with a revocation clause. This could well fall foul of any anti-forestalling measures announced at the budget. This is a common feature which may affect actions taken between the 30th of October and the end of the tax year when most measures are likely to come into place. It may also affect conditional arrangements which have not been finalised. Similar measures were introduced when Business Asset Disposal Relief replaced Entrepreneurs Relief with the allowance cut from £10m to £1m.

In choosing what gifts to give away, it is generally to choose items which either are not subject to CGT or where the chargeable gain is small, or indeed when one is crystallising a loss.

Foreign aspects

Inheritance Tax is a donor-based tax, as is Capital Gains Tax. One does however need to consider the residence and tax status of any donee as this may affect the overall effectiveness of protecting family wealth.

Family circumstances

One also needs to consider the potential impact of divorce on any family wealth. The general position has been a move towards clean break divorces. This means that if one gives away substantial amount to a child, it is quite possible that half of this would disappear if that child gets divorced. One way of protecting family assets would be to put the assets in trust for grandchildren and future descendants. This could protect the family assets.

One does need to bear in mind however that amounts that are put into trust above the nil-rate band will generally incur a 20% entrance charge. However, assets which are not subject to IHT or a full deduction at present such as AIM shares, unquoted UK trading shares etc. would not create an exit charge. The nil-rate band could be doubled by using the spouses unused band as well.

Conclusion

Although PET's sound deceptively simple, one should remember that the consequences are not just for Budget Day; they last a lot longer.

Contributed by Jeremy Mindell