

Order of Gifting

Case study



When looking at IHT planning, advisers should consider a client's overall assets, their history of previous gifts and the order in which they establish any new IHT planning structures.

Gifting in the right order is essential for effective ongoing estate planning and may well require the use of a number of different trusts. But getting it right could save inheritance tax.

Getting the order wrong could be costly.

A gift into a discretionary trust is a chargeable lifetime transfer (CLT) and should be made before a gift into a bare trust. The gift into the bare trust would be a potentially exempt transfer (PET) which could subsequently fail and become a chargeable transfer and therefore impact on the discretionary trust arrangement when any future periodic charges are calculated.

Periodic charges may arise on every tenth anniversary of the start of a discretionary trust, if the relevant value of the trust fund at that time, exceeds the available nil rate band (NRB) at that time. The available nil rate band used is the nil rate band on the ten-year anniversary, reduced by any other chargeable transfers or failed PETs made in the seven years before the start of the trust and any distributions of capital made to beneficiaries in the previous ten years.

Remember, on death, any transfers made during lifetime that become chargeable, are applied first against the NRB, in chronological order.

Further details are provided in our briefing note on the Order of Gifting.



Case Study:

Sidney has made some gifts over the past few years. He died suddenly in March 2021, leaving an estate of £2,000,000. He only has the standard nil rate band (£325,000) as he was living in rented accommodation. His professional adviser and the trustees need to calculate the total tax due, both now and in the future. The following calculations compare the difference in IHT and periodic charges; depending on how, and in what order, the previous gifts had been made:

Example 1: 'Wrong' order of gifting

Gift		
February 2013 (PET)	£100,000	Exempt
February 2017 (PET)	£100,000	Failed
September 2018 (CLT)	£325,000	

1. Calculate the effect of the gifts on Sidney's NRB:

NRB less value of failed PETs / previous CLTs within last seven years:

- £325,000 – £100,000 (2017) = £225,000. This is Sidney's remaining NRB
- CLT of £325,000 is in excess of Sidney's remaining NRB by £100,000 and taxable at 40% = **£40,000 IHT on the CLT, paid by the trustees**

No taper relief is available in this instance, as the CLT was within 3 years of Sidney's death.

2. Calculate the IHT on Sidney's estate:

The estate of £2,000,000 is fully liable to IHT, as the NRB has been fully used by the gifts.

Therefore all taxed at 40% = £800,000 paid by the estate

Total IHT due on Sidney's death is £840,000

3. Calculate the ten-year periodic charges:

In September 2028, the first periodic charge is due on the CLT (the trust now valued at £350,000):

NRB – previous failed PETS / CLTs

£325,000 - £100,000 (2017) = £225,000 available NRB.

Note: this £100,000 reduction in the trust's NRB will apply for all future periodic charge calculations!

The value of the trust fund (£350,000) is in excess of the trust's available NRB by £125,000 and this amount is taxable at 6%:

£125,000 @ 6% = **£7,500 paid by the trustees**

4. Exit charges

The exit charge in the first ten years of a CLT is based on the effective rate of tax the settlor paid (or could have paid) at the creation of the trust. So in this example, even though no entry charge was paid on the CLT the "failed" PET now uses up the available NRB and so the CLT now has a reduced available NRB and so has been deemed to have paid a hypothetical charge. Exit charges will therefore be calculated accordingly.

The exit charge after ten years is based on the effective rate of tax for the previous periodic charge.

Example 2: 'Correct' order of gifting

Gift		
February 2013 (PET)	£100,000	Exempt
February 2017 (PET)	£325,000	
September 2018 (CLT)	£325,000	Failed

1. Calculate the effect of the gifts on Sidney's NRB:

NRB less value of failed PETs / previous CLTs within last seven years:

- £325,000 – £325,000 (2017) Sidney's NRB has been fully used
- Failed PET of £100,000 is therefore taxable at 40% = £40,000 IHT on the CLT, paid by the beneficiary

No taper relief available in this instance, as the failed PET was within 3 years of Sidney's death.

2. Calculate the IHT on Sidney's estate:

The estate of £2,000,000 is fully liable to IHT, as the NRB has been fully used by the gifts.

Therefore all taxed at 40% = £800,000 paid by the estate

Total IHT due on Sidney's death is £840,000

3. Calculate the ten-year periodic charges:

In February 2027, the first periodic charge is due on the CLT (the trust now valued at £350,000):

The trust's available NRB is £325,000 as there were no failed PETS / CLTs within the previous seven years of this CLT

The failed PET made in 2018 does not reduce the NRB when calculating periodic charges on the CLT

The value of the trust fund (£350,000) is in excess of the trust's available NRB by £25,000 and taxable at 6%: £25,000 @ 6% = £1,500 paid by the trustees

4. Exit charges

The exit charge in the first ten years of a CLT is based on the effective rate of tax the settlor paid (or could have paid) at the creation of the trust, in this example, as the CLT retained its full available NRB, no exit charges should apply in the first 10 years.

The exit charge after ten years is based on the effective rate of tax for the previous periodic charge.

As you can see from these examples, although there is little, if any, impact on the IHT on death, consideration should be made to the impact on the subsequent periodic and exit charges. Making gifts in the correct order can reduce the potential future ongoing periodic and/or exit charges.



Key facts about gifting and IHT planning:

- Consider all of the client's assets as a whole, do not plan in isolation
- PETs made in the last seven years could possibly impact on new discretionary trust arrangements if the settlor dies within that seven year period
- Gifts into discretionary trusts can affect PETs made up to seven years later (referred to as the 14-year shadow) When considering more than one arrangement do them on separate days and in the correct order
- The entry, exit, and ten-year periodic charges which apply to flexible and discretionary trusts mean the order in which gifts are made into trust will impact immediate and future tax payable. Therefore, careful consideration is required.



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