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LIFETIME GIFTS & INHERITANCE TAX PLANNING

Lifetime gifts are an important part of inheritance tax planning. They can be an effective way of removing value from an individual's estate, which can reduce the amount chargeable to inheritance tax upon death. Not all lifetime gifts, however, will mitigate inheritance tax. If this is part of the desired result, it is necessary for such gifts to fall within certain exemptions.

A distinction can be made between gifts to individuals and gifts to trusts. Gifts to trusts allow individuals to retain control over the assets and give a certain degree of asset protection. Although the tax advantages of using trusts have been reduced in recent years, and the regulatory and administrative burden has increased, there are still ways in which these can be used to good effect. The list below is not an exhaustive one but gives examples of some of the options available when making gifts to individuals, trusts or both.

NORMAL EXPENDITURE OUT OF INCOME

This is potentially a very generous exemption which is often under-utilised. Lifetime gifts are exempt from inheritance tax if they form part of a person's regular expenditure out of their surplus income. In order for the exemption to apply, the following conditions must be met:

1. The payments in question must be part of normal expenditure – that is to say, there must be a regular pattern of giving;
2. The payments must be made out of income (rather than capital); and
3. The person making the gifts must be left with sufficient income to maintain their usual standard of living after those gifts have been made.

HM Revenue & Customs (HMRC) will expect to see evidence of the regular pattern of giving. It is also necessary to demonstrate that such gifts are, indeed, made out of surplus income and that the lifestyle of the person making the gifts is unaffected as a result. If relying on this exemption, it is a good idea to put in place records which reflect the type of evidence that HMRC will expect to see. This should include a detailed list of the date and value of the gifts and details of the recipient. HMRC will also look for details of income and expenditure for the years in which such gifts have been made (e.g. contemporaneous records), to show that surplus income was in fact available to make the gifts in question.

Provided that regular expenditure out of income can be demonstrated, there is no limit on the value of gifts that may be made under this exemption, making it a very beneficial exemption which can be used to good effect to gift to individuals or trusts.

GIFTS BETWEEN SPOUSES OR CIVIL PARTNERS

Gifts between spouses or civil partners are exempt from inheritance tax, provided both have the same domicile for inheritance tax purposes.

GIFTS TO CHARITY

Gifts to UK charities are fully exempt from inheritance tax.

SMALL GIFTS

Gifts to individuals totalling not more than £250 per person per tax year are exempt from inheritance tax. This means that a person can effectively reduce the size of their estate by making a series of gifts to different persons of up to £250 each throughout the course of the tax year. If a gift to a particular individual exceeds £250, then the exemption will not apply to any of that gift (not just the amount in excess of £250). Where a gift is under £250, it is not possible to carry any unused portion forward to the following tax year.

GIFTS ON MARRIAGE OR CIVIL PARTNERSHIP

Lifetime gifts on the occasion of a marriage or registration of a civil partnership are exempt up to certain limits. A parent can give a child up to £5,000, whilst grandparents and great-grandparents may gift up to £2,500. A maximum sum of £1,000 may be given by another person. Any such gift must be made before or at the time of the ceremony. The exemption will fail if the ceremony does not ultimately take place.

ANNUAL EXEMPTION

Lifetime gifts, which do not fall within any of the other exemptions, are exempt up to the value of £3,000 per tax year. If the annual exemption is wholly or partly unused for a particular tax year, that unused portion may be carried forward to the next tax year only. The annual exemption may also be used to exempt from inheritance tax the first £3,000 of a larger gift.

POTENTIALLY EXEMPT TRANSFERS—THE 7 YEAR RULE

This is not an absolute exemption, but is another useful tool in lifetime inheritance tax planning. Non-exempt gifts between individuals are classified as “potentially exempt transfers”. Provided that the person making the gift survives for a period of seven years from the date of that gift, it will fall out of account for inheritance tax purposes. Where death does occur within seven years, taper relief will apply after three years to reduce the value of any inheritance tax payable. For larger gifts, it can be possible to retain control over amounts gifted by using a corporate structure.

TRANSFERS INTO TRUSTS

Gifts into certain types of trusts attract an immediate charge to inheritance tax, but only to the extent that the value of those gifts exceeds the nil rate band (presently £325,000). The nil rate band replenishes itself every seven years. This means that it is possible to transfer significant value away from the estate during lifetime, by making regular seven-yearly gifts of the nil rate band allowance into trust (from which both spouses are excluded). Both spouses can make use of their respective nil rate bands so £650,000 can be put into trust by a couple every seven years.

PAVING THE WAY FOR FUTURE GIFTS

The way in which investments are made can have an impact on effective giving later and structures other than trusts (such as a family investment company) may be appropriate.

ALL CHANGE?

It is worth noting that inheritance tax has, in the past few years, been the subject of two reviews by the Office of Tax Simplification, as well as an informal report by the All-Party Parliamentary Group for Inheritance and Intergenerational Fairness. These reports all suggested changes (in some cases radical ones) to the current system, which is perceived to be unfair and unnecessarily complex. Although successive governments have so far not sought to implement any significant changes to these reliefs, the Labour government's first Budget proposed significant changes to agricultural property relief and business property relief, as well as to the taxation of non-UK domiciled individuals. Given these changes, it is worth considering making use of current exemptions and reliefs, as future reform could further alter the landscape.

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