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# making gifts

## post Finance Act 2006



Colin Jelley  
Head of Tax and Financial Planning

**Colin Jelley** establishes the basis for post March 2006 inheritance tax (IHT) planning using gifts to trusts and explains why the order in which they are made will have an important effect on future liabilities.

The Finance Act 2006 has introduced the relevant property regime which treats interest in possession (IIP) and Accumulation and Maintenance trusts, created after 21 March 2006, as discretionary trusts for IHT purposes.

Putting the new legislation (in Schedule 20 Finance Act 2006) into practice brings into play some additional considerations. The order in which you solve your clients' IHT problems may dictate the future taxes applicable to the trusts created.

Consider a client who wishes to create a trust for £285,000 for his young grandchild. He does not want to give them absolute access to these funds, so a discretionary trust provides the required flexibility and caters for any later additions to the family.

Additionally, he wished to make a gift of £285,000 to his two adult children using bare trusts. Combining both types of trusts means he can give away the £570,000 without any immediate liability to tax:

**Discretionary Trust £285,000** – available nil rate band (NRB) £285,000 for 2006/07 – chargeable lifetime transfer (CLT), entry charge £0.

**Bare Trust £285,000** – potentially exempt transfer (PET) – entry, ten year periodic and exit charges not applicable.

### order of events is key

At this point all the objectives seem to have been addressed. However, suppose the client dies eighteen months later.

Let's assume the residual estate has been passed, exempt from IHT, to his spouse, and his annual exemptions have been used elsewhere. We need to consider how the trusts will be taxed in future years. I will focus here on the ten year periodic charges and recalculation of tax on the gifts as, due to death occurring within seven years, both are now chargeable.

### PET before CLT

In this scenario the available NRB (£312,000 for 2008/09) would be allocated to the failed PET. This would leave £27,000 of unused NRB which can be used against the CLT.

The CLT would be taxed as follows: £285,000 minus £27,000 (= £258,000) x 40%, minus any tax paid on entry (nil) = £103,200 to pay\*.

This can be paid by the trustees, leaving a trust fund of £181,800. Assuming no exits in the first ten years and that the value of the discretionary trust has grown to £400,000, the calculation of the first ten year periodic charge will be:

- Chargeable transfers within seven years prior to the creation of the discretionary trust = £285,000 (the failed PET). Plus £400,000 (the current discretionary trust value) = £685,000

- Less (assumed) NRB for tax year 2016/17 of £375,000 = £310,000 x 20% lifetime rate = £62,000
- Effective rate (£62,000/£400,000) x 30% = 4.65%
- Tax due = 4.65% x £400,000 = £18,600

### CLT before PET

If, alternatively, the PET had been made after the CLT, the ten year periodic charge would be as follows:

- Chargeable transfers within seven years prior to the creation of the discretionary trust = £0 (failed PET is after CLT). Plus £400,000 (the current discretionary trust value) = £400,000
- Less (assumed) NRB for tax year 2016/17 of £375,000 = £25,000 x 20% lifetime rate = £5,000
- Effective rate (£5,000/£400,000) x 30% = 0.375%
- Tax due = 0.375% x £400,000 = £1,500

### summary

The moral in advising on making a discretionary trust is to ensure that the settlor always has as 'clean' a gifts history as possible.

Further, if a settlor is minded to make a PET (eg an outright gift) and a chargeable lifetime transfer (eg a discretionary settlement) at the same time, he should be advised to make the chargeable transfer first.

\*Taper relief would be zero, as death occurred within the first 36 months.

This document is based on Skandia's interpretation of the law and HM Revenue & Customs practice as at 31 August 2006. We believe that interpretation is correct, but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

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