Technical Insights - Quick Reference Guide

The order of making gifts

Gifting is an important part of Inheritance Tax (IHT) planning. Anyone can make a gift, but you can really demonstrate the value of your advice by mastering the detail. One key detail to get right is the order of gifting. This outlines why making Chargeable Lifetime Transfers (CLTs) before Potentially Exempt Transfers (PETs) can save tax.

What is the optimal order?

1st Chargeable Lifetime Transfer (CLT) → 2nd Potentially Exempt Transfer (PET)

Chargeable Lifetime Transfer (CLT)	A gift to a 'relevant property trust'. This includes all discretionary trusts and Flexible Power of Appointment trust / Interest in Possession Trusts created by a lifetime gift after March 2006.
Potentially Exempt Transfer (PET)	A gift made directly to an individual or to an absolute (bare) trust.

CLT before PET potentially reduces the periodic charge

By making a CLT, your client is creating a new relevant property trust. These trusts are subject to a 10 yearly periodic charge. The charge tests the value of the trust fund above the available nil rate band. The maximum charge is 6% of the trust fund.

How?

For the purpose of calculating the periodic charge, the trust is given a nil rate band (currently £325,000*) which is reduced by:

- CLTs made in the 7 years immediately before the trust started.
- Failed PETs made in the 7 years immediately before the trust started.

If your client dies within 7 years of making their PET, it will become a failed PET. If the PET was made before the CLT, then it will reduce the available nil rate band and potentially increase the periodic charge. Successful PETs and exempt gifts are not included in the calculation.

Exit charges are also affected

The rate of tax applied at the periodic charge is used to calculated the exit charge which applies when capital is distributed from the trust. By reducing the periodic charge, you're also reducing the exit charge.

For more details on periodic charges, refer to our quick reference guides **here**.

** The nil rate band (NRB) is currently frozen until April 2028.*

For financial advisers only

Example 1

Let's look at an example to show how the order of gifting can affect the periodic charge.

You've advised your client to create a discretionary trust with a CLT of £300,000 and a direct gift to their children creating a PET of £100,000. They have not made any previous gifts. They die within 7 years of the recommend gifts.

On the 10th anniversary the trustees of the discretionary trust calculate the periodic charge. The trust's value is £400,000 and the nil rate band is £325,000. A simplified periodic charge calculation is given below.

PET before CLT

£400,000
minus
£225,000 available NRB
x 6%
= **£10,500** Periodic Charge

- £100,000 failed PET reduces the trust's NRB
- £225,000 NRB now available

CLT before PET

£400,000
minus
£325,000
x 6%
= **£4,500** Periodic Charge

- No failed gifts in the 7 years prior to the trust start date
- The trust's NRB £325,000

CLT before PET saved £6,000

Check the figures yourself with Quilter's guide to the periodic charge **here**.

Gifting alongside loan trusts

A loan trust is an arrangement where the settlor lends a cash sum to a trust which can be recalled at any time. The trustees invest the cash and any investment growth is held on trust for the beneficiaries. This trust is commonly used where there is, or will be, an IHT liability but the an individual does not wish to forego access to the capital - since the loan can be recalled at any time.

The optimal order for loan trusts and Gifts

1st Loan trust → 2nd Chargeable Lifetime Transfer (CLT) → 3rd Potentially Exempt Transfer (PET)

The correct order potentially reduces the periodic charge

Where a loan is made to a relevant property trust, (such as a discretionary loan trust), the growth achieved by the trustee's investment is subject to the periodic and exit charges (described above).

As with other relevant property trusts the available nil rate band is reduced by failed PETs and CLTs in the 7 years prior to creation. It's therefore important to get the order correct.

Example 2

Your client would like to address their IHT liability and put aside £525,000 for their children which they'd like to place into discretionary trust. However, they're unsure whether they want to forego access to all the capital in the future. They also do not wish to pay the entry charge which would apply when making a CLT over their nil rate band. They have made no previous gifts.

You suggest they could make a CLT up to £325,000 and then lend the remaining £200,000 to a discretionary loan trust instead. This gives them the discretionary trust structure they're looking for, does not incur an entry charge and provides access through repayment of the loan.

What difference could the order make?

On the 10th anniversary of the trusts, the discretionary gift trust is worth £425,000. The growth on the loan trust is £60,000. The nil rate band (NRB) is £325,000. A simplified periodic charge calculation for the loan trust is given below.

CLT before loan trust

£60,000
minus
£0 available NRB
x 6%
= **£3,600** Periodic Charge

- £325,000 previous CLT reduces the NRB
- £0 NRB now available

Loan trust before CLT

£60,000
minus
£325,000 available NRB
x 6%
= **£0** Periodic Charge

- There are no previous CLTs to reduce the available NRB

Loan trust before CLT saved £3,600

The information provided in this article is not intended to offer advice.

It is based on Quilter's interpretation of the relevant law and is correct as of August 2024. While we believe this interpretation to be correct, we cannot guarantee it. Quilter cannot accept any responsibility for any action taken or refrained from being taken as a result of the information contained in this article.

QIP 23340/107/7760/August 2024