

Inheritance tax – taper relief

Introduction

This factsheet explains how taper relief can reduce an inheritance tax (IHT) liability where an individual dies between three and seven years after making a potentially exempt transfer (PET).

Taper relief can also reduce the tax liability arising from chargeable lifetime transfers but this subject is outside of the scope of this factsheet.

PETs

A PET is a gift that is:

- not covered by any of the available IHT exemptions; and
- not immediately chargeable to IHT.

The value of a PET will fall completely outside of the donor's estate, for IHT purposes, if the donor survives for seven years after the date of the gift.

If an individual dies within seven years after making a PET then the value of that PET would be aggregated with the deceased's free estate to determine what, if any, IHT is due. The PET will therefore use up some or all of the available nil-rate band (NRB), potentially exacerbating or even creating an IHT liability for the estate.

Also, if the value of the PET exceeds the NRB, current at the date of death, then additional IHT will be payable by the recipient of the gift. Taper relief may reduce the amount of tax payable.

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The relief

Where tax is due on a PET, the availability of taper relief depends on how long the donor survived after making the gift. The percentage of the full tax rate payable is as follows:

Number of years survived between gift and death	Percentage of full tax rate payable	Effective rate of tax on a taxable PET
less than 3	100%	40%
3 to 4	80%	32%
4 to 5	60%	24%
5 to 6	40%	16%
6 to 7	20%	8%

It is important to appreciate that taper relief can only reduce any IHT liability, resulting from a PET becoming chargeable on death, and does not reduce the value of the gift itself.

Example 1

Maureen gave her son, Jack, a gift of £500,000. If Maureen died in July 2009 the amount of IHT payable by Jack would depend upon how many years had elapsed between the date of the gift and Maureen's death. Jack's tax bill would vary as follows (based on a NRB of £325,000 and assuming that Maureen had no other taxable estate and had otherwise used her £3,000 annual exemption in the tax year of the gift):

No. of years between gift and death	Tax liability
up to 3	£70,000
3 to 4	£56,000
4 to 5	£42,000
5 to 6	£28,000
6 to 7	£14,000
7 or more	Nil

The liability for death in the first 3 years is based on 100% of the full death rate, in this example $100\% \times 40\%$ of $(£500,000 - £325,000) = £70,000$. The decreasing liabilities, for periods greater than three years, reflect the impact of taper relief.

Example 2

Maureen made a gift of £250,000 to Jack, in 2004. This is a PET and she has made no other gifts. If she were to die at any time during the following seven years, assuming that the NRB is not lowered to below £250,000, there will be no IHT liability for Jack, as the PET donee. It therefore follows that with no tax liability there can be no application of taper relief. Her death in this timeframe would, however, reduce the NRB available to her estate by £250,000.

Multiple gifts

Where someone has made a number of PETs, in the seven year period before their death, these are offset against the available NRB, in strict chronological order. The earliest PET sits at the bottom of the pile and later PETs are 'stacked' on top of this, in date order, with the most recent gift resting on top.

Where the total value of the PETs is greater than the NRB, then the earliest PET is the first to be offset, against the NRB, followed by the next earliest and so on. Only those PETs that exceed, in full or part, the NRB will attract an IHT liability and it is therefore only these PETs that can qualify for taper relief.

Example 3

Bill makes PETs to his daughter Sally of £200,000 in August 2003 and £180,000 in August 2005. He also makes a PET of £70,000 to his son David in June 2008. Bill died in July 2009. The cumulative value of the PETs is £450,000 and this exceeds the £325,000 NRB by £125,000. The IHT liability is calculated as follows:

Date of gift	Value	Available NRB	Taxable amount	IHT liability
August 2003	£200,000	£325,000	Nil	Nil
August 2005	£180,000	£125,000	£55,000	£17,600
June 2009	£70,000	Nil	£70,000	£28,000 ²

- 80% of the full death rate applies to this PET as it was made between 3 and 4 years before Bill's death.
- No taper relief applies to this gift as it was made within 3 years of Bill's death.

Financial planning points

The following points also need to be taken into account when calculating the potential IHT liability resulting from PETs.

- It is the value of the PET at the date of the gift that is used in any IHT calculations. If the value of the gifted assets has fallen, since the date of the gift, it may be possible to substitute the lower value for IHT purposes.

This is known as “fall in value” relief and can be claimed by a person liable to pay tax as the result of a failed PET. The main qualifying criteria for this relief are:

- the property gifted must still be owned by the donee and have a lower market value, at the date of the donor’s death, than at the time of the gift; or
 - where the donee has sold the gifted property before the donor’s death, the sale must have been at arm’s length to an unconnected person and the market value of the gifted property, at the date of the sale, must be lower than at the time of the gift.
- Certain gifts made up to 14 years before death could be included when calculating tax due on a PET. This is because any chargeable transfers, for example gifts into a discretionary trust, made in the seven year period before a PET must be taken into account when determining whether tax is due on that PET (see example 4).
 - Non-exempt gifts into bare and disabled interest trusts are also classed as PETs.

Example 4

Simon made a PET valued at £300,000 to his daughter Rachel in July 2007. Simon died in May 2009. Rachel believed that she had no IHT liability, as the PET donee, on the basis that Simon had not made any other gifts in the 7 year period ending in his death and the gift fell entirely within the £325,000 NRB. Unfortunately Rachel did have a tax liability as Simon had settled £100,000 into a discretionary trust (which was a chargeable transfer) in August 2000 and this was within 7 years of the date of the PET. The IHT calculation for the PET was therefore:

$$(\text{£}300,000 + \text{£}100,000 - \text{£}325,000) \times 40\% = \text{£}30,000$$

Rachel had an IHT bill for £30,000 even though the chargeable transfer was nearly 9 years before Simon’s death. The £100,000 chargeable transfer was ignored for the purposes of the IHT calculation for Simon’s estate, as it was made over 7 years before his death.

Important information

This factsheet is based upon our understanding of current tax and other legislation at the release date and may be subject to change in the future. Whilst every care has been taken to ensure the accuracy of this information, Friends Provident can accept no responsibility for any actions taken as a result of this release.

Release Date 15/10/09