

Inheritance Tax - Efficient Wills

Introduction

Until October 2007 it was increasingly valuable for married couples to seek to use the Inheritance Tax (IHT) allowance (known as the nil rate band) applicable at the time of the first death, in addition to the allowance which would in any case be available when the survivor died. The same was true for civil partners, who are covered by all references below to spouses or married couples.

The nil rate band currently stands at £325,000 and is to remain at the same level until 5 April 2015.

The simplest way of making use of the nil rate band on the first death was to leave an equivalent sum directly to children or other intended beneficiaries. The main drawback, however, was that the amount involved could not then be available to the surviving spouse.

The way round that was commonly to leave a legacy on the first death equivalent to the nil rate band to a Discretionary Trust which included the survivor, children and others as possible beneficiaries. This arrangement is more fully discussed in our information sheet 'Nil Rate Band Discretionary Trusts in Wills for Spouses or Civil Partners'. To fit in with this strategy, in many cases spouses owned their homes as tenants in common, so that a share of the house could be used to satisfy the legacy.

New Law

In the Pre-Budget Statement on 9 October 2007 it was announced that the unused nil rate band on the first spouse's death would be 'transferable' to the survivor. Actually,

the change was more generous than that, since the nil rate band on the survivor's death (which may be considerably higher by that time) can now be increased by the proportion of the nil rate band which is not used on the first death.

For example:

- 1 If on the first death the whole estate passes to the survivor and there have been no lifetime gifts, 100% of the nil rate band will be unused. If the nil rate band on the survivor's death is set at £500,000, this can be doubled to £1,000,000.
- 2 If, however, the first deceased had made gifts of £40,000 within seven years of their death in 2007/08, having left non-exempt legacies in their Will totalling £20,000, they will have used £60,000 of the then nil rate band of £300,000. The unused balance of £240,000 (being 80% of the nil rate band) will not be transferred to the survivor, but instead the survivor's nil rate band can be increased by 80%. So, if the nil rate band on the survivor's death is set at £500,000, it can be increased to a total of £900,000.

Who Can Benefit?

The transferable nil rate band is available to all survivors of a marriage or civil partnership who die on or after 9 October 2007, no matter when the first spouse died or dies. If the surviving spouse has been married more than once before, the unused nil rate band on each previous spouse's death can be used but not so as to more than double the nil rate band on the survivor's death.

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Effect on IHT Planning

The current law is likely to make nil rate band Discretionary Trusts on the first death redundant in most cases.

If there are legacies within the nil rate band on the first death directly to the children or other beneficiaries who will also inherit on the survivor's death, they should be reviewed. It is almost certainly preferable for the survivor to inherit most, if not all, of the estate (either outright or with a life interest) and to make lifetime gifts as potentially exempt transfers (PETs) to the eventual heirs.

In that way, if the survivor lives for at least seven years after the gifts, they will not count for IHT, and in addition the survivor's nil rate band can be doubled.

For example, assume that the nil rate band on the first death is £350,000 and on the second death it is £500,000, and that asset values do not change:

- 1 If the nil rate band is fully used on the first death, the assets which can escape IHT will be £350,000 + £500,000 = £850,000.
- 2 If instead the estate on the first death passes to the survivor, who then makes PETs of £350,000 and survives for seven years, the assets which can escape IHT will be £350,000 (the PETs) + £1,000,000 = £1,350,000.
- 3 Even if the survivor fails to survive the PETs by seven years, the position will still be better than if the nil rate band had been used on the first death:

- a If, having made the PETs, the survivor dies when the nil rate band is £400,000, the assets which can escape IHT will be £350,000 (the PETs) + £450,000 (£800,000 - £350,000) = £800,000.
- b Conversely, if the £350,000 of gifts had been made under the first spouse's Will, the assets which could escape IHT would be £350,000 + £400,000 (the survivor's uninflated nil rate band) = £750,000.

Remaining Advantages of Trusts?

A nil rate band Discretionary Trust may still be worth considering if there is an asset, for example development land, which can be expected to rise in value very significantly during the survivor's lifetime. For example, if property worth £300,000 is allocated on the first death to a Discretionary Trust and it is worth £1,000,000 by the survivor's death, it will then not be taxable with the survivor's estate. If at the survivor's death the nil rate band was then £500,000, a total of £1,500,000 of assets could escape IHT. However, had the nil rate band trust not been established, the property would have passed to the survivor and only £1,000,000 (the doubled nil rate band) could escape IHT on their death.

If either or both spouses have previously been widowed, there may be three or four available nil rate bands, and a Discretionary Trust of up to two of them may still be appropriate.

A non-tax advantage of a trust is that it could shelter the assets within it from means-testing or financial claims which the survivor may face.

The overall situation is, however, not quite

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so clear cut. First, there would be the costs of creating and running the Discretionary Trust. Secondly, the trust could face IHT charges every ten years at up to 6% of the value. Thirdly, in the above example the trust would have a capital gain of £700,000 prospectively liable to Capital Gains Tax (CGT), whereas that gain would have been wiped out CGT-free on the survivor's death had they inherited the property outright.

Simplicity and Procedure

The change in the law simplifies the drafting of married couples' Wills and also the administration of their estates.

The IHT position on the survivor's death should be relatively straightforward, provided there is a record of the unused balance of the nil rate band on the previous death(s) of the spouse or spouses. In addition, it will be necessary to produce for each previous spouse:

- 1 the death certificate;**
- 2 the marriage (or civil partnership) certificate(s);**
- 3 a copy of the grant of representation;**
- 4 a copy of any Will and Codicil(s), and any Deed of Variation.**

The claim to transfer unused nil rate band must be made by the survivor's personal representatives using form IHT402. Normally it must be submitted within two years from the end of the month in which the surviving spouse dies.

Business and Agricultural Property

It is normally still desirable for there to be a specific legacy on the first spouse's death of business or agricultural assets, particularly if they are eligible for 100% relief from IHT. This may be done by outright legacies to children or other beneficiaries or by a legacy to a Discretionary Trust. Advice should be obtained where there are such assets.

Existing Wills

If couples already have nil rate band Discretionary Trusts in their Wills, they are not harmful. It will be possible within two years of the first death for the Discretionary Trust to be ended, by transferring the assets either outright or in trust to the surviving spouse, and to that extent leaving the nil rate band unused on the first death.

Wills leaving legacies on the first death to the eventual heirs should be reviewed. If they remain as they are, it will be possible for the children within two years of the first death to do a Deed of Variation in favour of the surviving spouse intended to liberate the nil rate band on the first death.

The potential expense, delay and complications associated with these measures can, however, be avoided if the requisite changes are made by Codicils or in entirely new Wills before the first death.

If a couple own their house as tenants in common and change their existing Wills, it will be possible to make them joint tenants,

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so that a half share of the property on the first death passes automatically to the survivor. Clearly, that change will not be appropriate if the survivor's interest in the estate is to be held in trust.

New Wills

We will not normally recommend including nil rate band Discretionary Trusts in new Wills.

Other IHT Planning

The above comments relate only to arrangements in IHT-efficient Wills. There may well be other areas for IHT planning which need to be discussed.

Disclaimer

This information sheet is written as a general guide. As any course of action must depend on your individual circumstances, you are strongly recommended to obtain specific professional advice before you proceed. We do not accept any responsibility for action which may be taken as a result of having read this information sheet.

NOTE: The law is stated as at May 2011.

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