

Nil Rate Band Discretionary Trusts in Wills for Spouses or Civil Partners

Introduction

On death, a person's estate is liable to Inheritance Tax (IHT) at 40% to the extent, if any, that its value exceeds the current threshold of £325,000. The amount below that threshold is called the nil rate band because it is charged to IHT at nil%. It is reduced by any gifts made in the 7 years before death and legacies in the Will which are not exempt. The unused balance is referred to below as the IHT-free amount.

Assets passing either outright or in trust between spouses* are exempt from IHT. If, however, spouses simply leave their estates to each other, the combined value will be liable to IHT on the survivor's death, subject to the IHT-free amount available at that time. No use will have been made of the IHT-free amount available on the first death.

Until the Pre-Budget Statement on 9 October 2007, it was common practice to make use of the IHT-free amount on the first death and often by means of a Discretionary Trust, but the position is now different. Where a surviving spouse dies on or after that date then, to the extent, if any, that the IHT-free amount has not been used on the death of the first spouse, the survivor's IHT-free amount can be increased. This is explained more fully in our information sheet Inheritance tax - Efficient Wills.

Therefore, it may actually be disadvantageous now to use the IHT-free amount on the first death. However, there may be cases, for example where a widow or widower has remarried and whose first spouse did not use their IHT-free amount, when a nil rate band Discretionary Trust in the Will may still be appropriate.

What is said below applies to the Discretionary Trust arrangement on the first spouse's death, either where the trust has already been set up, or in the relatively few cases where it is still desired to have such an arrangement in Wills which are now being made.

Although assets equivalent to the IHT-free amount can be given on the first death to children or other beneficiaries apart from the surviving spouse, in the majority of cases this will leave insufficient assets to ensure that the survivor can continue to enjoy the same standard of living as before. By using a Discretionary Trust of the IHT-free amount on the first death, it is possible to reduce the IHT bill on the second death significantly, while allowing the survivor to benefit financially before then, not only from their own assets but also from the whole of their deceased spouse's estate. A formula is employed to use up the IHT-free amount applicable on the first death.

This arrangement was not adversely affected by the 2006 changes to IHT.

The Discretionary Trust

A Discretionary Trust is so called because no beneficiary has a fixed entitlement and the trustees have complete discretion to decide what, if any, benefits should be allocated to the beneficiaries. The trustees can distribute income and/or capital among a defined class of possible beneficiaries, including the surviving spouse, any children and grandchildren and such other beneficiaries as may ever conceivably be intended to benefit. Mere inclusion in the class does not confer any legal right to receive any benefit, and it is entirely up to the trustees to decide how the trust assets

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should be used.

The flexibility of the arrangement enables the trustees, after the first death, to decide what should happen. The aim of the exercise is for the trustees, at their discretion, to pay any income from the trust to the survivor, or to allow the survivor the use of any property (or share in any property) comprised in the trust, throughout their lifetime, but without the capital value being liable to IHT on the survivor's death. If necessary, some or even all of the capital can be transferred to the survivor although, to the extent to which it is, the IHT saving on the survivor's death will be lost. Similarly, provided the survivor has sufficient other assets, some or all of the capital can be made over to children or other beneficiaries during the survivor's lifetime. It will normally be intended that, after the survivor's death, the trust will be wound up and the assets distributed to the children or other appropriate beneficiaries.

Both spouses may find it reassuring if a letter of wishes has been addressed to the trustees asking them, albeit in a non-binding way, to regard the survivor as the principal beneficiary, and providing guidelines as to how the trust assets should eventually be distributed.

The IHT Saving

The capital value of the trust, whatever it may then be, will not form part of the survivor's estate for IHT purposes. The trust is a separate taxable entity. Subject to the point made in the Introduction about the transferable IHT-free amount, the maximum IHT saving on the second death at current tax rates (assuming no change in value within the trust) is $£325,000 \times 40\% =$

$£130,000$ (although a larger saving may be possible if assets qualifying for Business or Agricultural Property Relief on the first death are allocated to the trust).

During the survivor's lifetime, there can be no IHT during the first 10 years (unless assets which qualified for Business or Agricultural Property Relief are allocated to the trust). Thereafter, there may be relatively small liabilities to IHT every 10 years or when distributions of capital are made. The charges are likely to be insignificant, unless the assets show exceptional increases in value, and in any event cannot exceed 6% on any occasion.

The Trustees

In the light of the complete discretion conferred on the trustees, care is required when choosing who should act in this role. Normally, the survivor will be one of the trustees but should not be the only one. Adult children or other family members can be appointed although, if they also have a personal interest in the trust, it may be preferable to appoint one or more professional or other independent trustees. As the trustees will have to act unanimously, any one of them effectively has a power of veto.

Appropriate Assets

For the arrangement to work in whichever order the spouses die, they must each own sufficient assets to use up the IHT-free amount. This may require some equalisation of the estates subject, of course, to other considerations. If the main residence, or a share therein, is the only significant asset owned by the spouses, the Discretionary Trust arrangement needs to

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be considered particularly carefully.

If jointly-owned property is used, it must be owned by the spouses as tenants in common rather than as joint tenants so that, on the first death, the deceased's Will applies to their share rather than it passing automatically to the survivor. An existing joint tenancy can be severed and converted into a tenancy in common.

Generally, it is preferable for investments, cash or other assets to be allocated to the trust. However, it may be possible for the assets which otherwise would pass into the trust to be transferred to the surviving spouse charged with a debt due to the trust. The survivor then owns the assets but the value of the debt, which can be index-linked, should be deductible for IHT purposes. If done in the right way, no liability to Stamp Duty Land Tax should arise on this arrangement.

The precise way in which the trust is to be established will be decided after the first death.

Other Taxes

1 Income Tax

Trustees generally have to pay Income Tax at 50%, subject to a £1,000 standard rate band. Different rules apply to dividend income. Although trustees pay tax at a special rate of 42.5% when receiving dividends, they may have additional Income Tax to pay if they distribute the net balance. Each case must be looked at separately.

2 Capital Gains Tax (CGT)

The trustees will pay CGT at a flat rate of 28% in respect of any capital gains exceeding their available annual exemption, presently being a maximum of one half of the individual's annual exemption. Although there will be no uplift in the base value of trust assets on the survivor's death for CGT purposes, when they are subsequently distributed it should be possible to defer payment of the tax by an election for hold-over relief.

Other Factors

A Discretionary Trust needs to be properly administered. This involves the trustees filing annual Tax Returns and issuing appropriate tax deduction certificates to beneficiaries who have received income. The trustees should also maintain trust accounts and properly manage the trust's property or investments. The amount of administrative work will depend on the nature of the trust assets and on the frequency or otherwise of distributions of income and capital.

Conclusion

In the right circumstances, nil rate band Discretionary Trust provisions in Wills provide a married couple with an opportunity to reduce their potential IHT liability significantly, while still allowing the survivor to benefit from all of the assets which the spouses presently enjoy between them. The arrangement is extremely flexible.

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However, as mentioned in the Introduction, the Discretionary Trust arrangement may well be an unnecessary complication in most cases where the surviving spouse's death occurs on or after 9 October 2007.

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 6 April 2011.

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* All references to the term 'spouse' include a civil partner as defined by Section 1 of the Civil Partnership Act 2004

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