



IHT: when to consider will trusts and nil rate band planning

Recent consumer research by Legal & General* reveals that while 69% of people are aware of their potential IHT liability, the majority have taken no steps to eliminate this liability other than to make a will. In this issue of Wealth Management Alert we look at some of the benefits of using will trusts to reduce IHT.

Most UK trusts, other than absolute or care trusts, are settlements for inheritance tax (IHT) purposes and are considered related settlements if they have the same settlor and start on the same day. However, a judgement in the case of Rysaffe Trustees Co Ltd V IRC (2002) suggests a series of smaller trusts established on separate days are not considered to be related settlements. This means that each trust has a nil rate band to offset against the periodic charge to IHT which arises on each tenth anniversary of the trust. While any IHT that may become payable on creating a trust cannot be avoided, creating a series of smaller trusts may reduce or eliminate periodic and any resulting exit charges, as the following scenarios show:

Discretionary loan trust

Loan trusts (with no initial transfer of value) are an obvious vehicle for such a strategy, particularly if the settlor has not made substantial chargeable lifetime transfers in the seven years preceding the start of the first trust. This is because, even after allowing for any outstanding loan, the net value of a single trust could be in excess of the available nil rate band by the first 10 year periodic charge. Setting up a series of discretionary loan trusts on different days could eliminate or reduce the possibility of a 10-year periodic charge and subsequent exit charges.

Scenario 1

Peter sets up a discretionary loan trust for £1 million which, for the purpose of this example, grows in value to £2 million at the end of 10 years. He had not made any gifts in the preceding seven years other than to use his annual exemptions, and had not taken any loan repayments. Assuming that the nil rate band has increased to £425,000, at the end of 10 years the periodic charge would be 6% of the excess over the nil rate band after deducting the outstanding loan, that is $£1,000,000 - £425,000 \times 6\% = £34,500$. This would result in an effective rate of 3.45% ($£34,500 \div £1,000,000 \times 100$). When working out the exit charge for any later withdrawals this would be reduced by the appropriate fraction based on complete quarters elapsed since the last 10 year anniversary.

Scenario 2

John, on the other hand, sets up four identical discretionary loan trusts on separate days, each for £250,000, which also double in value after 10 years. Again, he had not made any gifts in the preceding seven years other than to use his annual exemptions, and had not taken any loan repayments. As none of the settlements would be related (based on Rysaffe), the value of each trust at the end of 10 years, after deducting the outstanding loan, would be absorbed by the nil rate band of £425,000 available for each trust.

Trust	Value at 10 years	Available nil rate band	10 year periodic charge
1	£250,000	£425,000	Nil
2	£250,000	£425,000	Nil
3	£250,000	£425,000	Nil
4	£250,000	£425,000	Nil

This would result in a zero tax charge – saving £34,500. It would also avoid any exit charges on any withdrawals in the subsequent ten years.

Discretionary gift trusts

Settlors can also make savings if the initial transfer into the trust is a chargeable lifetime transfer (CLT) and subject to the 20% IHT charge on any excess over the available nil rate band. A series of discretionary gift trusts could be set up on different days to avoid or lessen the possibility of a 10 year periodic charge and the exit charges that would result from this.

With a will trust a client can:

- retain full access to and control over their capital during their lifetime
- take regular withdrawals from a bond if required during their lifetime
- use their nil rate band without having to compromise the financial security of their surviving partner
- provide the surviving partner with access to capital in the will trust via loans repayable on death
- reduce the inheritance tax liability on the death of the surviving partner
- be certain the nil rate band will be used on the death of the first partner
- potentially safeguard against the impact of nursing home fees and the costs of long-term care.

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Scenario 3

Andrew sets up a discretionary gift trust for £400,000 that is valued at £700,000 after 10 years. He had not made any gifts in the preceding seven years other than to use his annual exemptions and had not made any withdrawals. The initial transfer would create a tax liability, paid by the trustees on entry, of £15,000 (£400,000 - £325,000 nil rate band x 20%). As the value of the trust had reached £700,000 at the end of 10 years and assuming that the nil rate band has increased to £425,000, the periodic charge would be £16,500 (£700,000 - £425,000 x 6%).

Scenario 4

Mark takes a different approach and sets up four identical discretionary gift trusts on separate days, each for £100,000, that are valued at £175,000 at the end of 10 years. Again, he had not made any gifts in the preceding seven years, other than to use his annual exemptions and had not taken any withdrawals. The nil rate band available of £325,000 will absorb the initial transfer into each of the first three trusts. However, the transfer into trust four would exceed the remaining nil rate band and create a tax liability on entry of £15,000 (£100,000 - £25,000 x 20%). While the entry charge

is identical to the single trust strategy, there would only be exit charges on any withdrawals in the following 10 years from trust four. As none of the settlements would be related (based on Rysaffe), each trust will have its own available NRB which will be reduced by any previous CLTs made in the seven years before setting up the trusts. Therefore, in this example the available nil rate band would absorb the value of each trust at the end of 10 years as follows:

Trust	Value at 10 years	Available nil rate band	10 year periodic charge
1	£175,000	£425,000	Nil
2	£175,000	£325,000 (£425K - £100K)	Nil
3	£175,000	£225,000 (£325K - £100K)	Nil
4	£175,000	£125,000 (£225K - £100K)	£3,000 (£50K x 6%)

This would result in a tax saving of £13,500 (£16,500 - £3,000) and there would only be exit charges on any withdrawals in the subsequent 10 years from trust four.

We would like to thank Legal & General for its input into this article.

When it might make sense to use the first nil rate band

The introduction of transferable nil rate bands in 2007 seemed to reduce the need for complex planning in wills. For some couples this is indeed the case. However there are still many instances where using the nil rate band on the first death could be appropriate:

- **Serial marriages:** a surviving spouse can only transfer up to one additional nil rate band in addition to his or her own. If they are likely to remarry, using a will trust on the death of the first spouse can ensure that any unused nil rate band is available for future use.
- **Avoiding the local authority charge and means-tested benefits:** leaving assets to a trust rather than to a surviving spouse or registered civil partner removes the value of those funds from the survivor's estate; therefore they may not be taken into

account when assessing eligibility for various charges and benefits.

- **Passing wealth to children:** a trust may be appropriate if the children are not to have immediate enjoyment of or access to the assets, eg, because they are too young or there is a risk of divorce or creditors making a claim.
- **Trust loans:** trustees can make loans to the surviving spouse. Any loan outstanding when they die would be treated as a debt against their estate.

- **Asset values expected to increase significantly:** assets such as shares in private companies or property may be expected to grow in value faster than any increases in the nil rate band. Keeping such assets outside an estate can limit the impact of IHT.
- **Remarriage:** someone might want their widow or widower to have an immediate life interest in their assets but for the capital to pass to their children should their partner remarry or die.

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