

## NIL-RATE BAND DISCRETIONARY TRUST

On death, estates are liable to inheritance tax ("IHT") at 40% to the extent, if any, that their value exceeds the current threshold of £285,000. The amount below that threshold is technically 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 between spouses are exempt from IHT. However, if 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.

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 will 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 significantly to reduce the IHT bill on the second death while also allowing the survivor to benefit financially, not only from their own but also from the whole of their spouse's estate. A formula is employed to use up the IHT-free amount applicable on the first death.

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, who are defined within a class. The trustees can distribute income and/or capital among the defined class of possible beneficiaries, including the surviving spouse, any children and grandchildren and such other beneficiaries as have been included.

Mere inclusion in the class does not confer any legal right to receive any benefit, merely a right to have a claim from the trust considered by the trustees. It is entirely up to the trustees to decide how the Trust assets should be used.

The flexibility of this arrangement enables the trustees after the first death to decide what should happen. The trustees at their discretion may pay income from the Trust to the survivor, or to allow the survivor to use any property (or share in the 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 second 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.

Provided the survivor's interest in the Trust remains only discretionary, 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. The maximum IHT saving on the second death at current tax rates (assuming no change in value within the Trust) is, therefore,  $£285,000 \times 40\% = £114,000$  (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

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

For the arrangement to work in whichever order 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. The only or main residence, or a share therein, is not an ideal asset to allocate to the Trust, because of the danger of the survivor being regarded by the Revenue as being taxable as an outright owner by virtue of their continuing rent-free occupation. If such a residence is the only significant asset owned by spouses, the discretionary trust arrangement needs to 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 quite easily.

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 against a debt (normally unsecured) due from the survivor to the Trust. The survivor then owns the assets but the value of the debt, which can be index-linked, should be deductible from the survivor's estate.

Apart from IHT, the trustees will generally have to pay income tax at 40%. Special rules now apply to dividend income. Although the Trustees will still suffer tax at approximately 40% overall when receiving dividend income, they may have additional income tax to pay if they distribute the net balance. Each case must be looked at separately.

The trustees will pay CGT at a flat rate of 40% (subject to any taper relief) in respect of any capital gains exceeding their available annual exemption, presently a maximum of £4,400.

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

In the right circumstances, nil rate band discretionary trust legacies provide a married couple with an opportunity to reduce the eventual 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.