

INHERITANCE TAX & TRUSTS

Introduction

With the ever-increasing value of property, more and more estates are being caught by this tax. This guide explains if and how this tax may affect you and your family and provides some measures that can be taken to reduce or even remove this tax completely over time. As independent financial advisers we provide a free estate review service to ascertain what liability could be incurred and importantly, if so, what action can be taken to avoid the Revenue becoming a direct beneficiary of your estate.

Many individuals go through their working lives trying to avoid paying tax by taking advantage of schemes that offer tax saving opportunities such as Pensions, Personal Equity Plans, Individual Savings Accounts and Tax Exempt Special Savings Accounts. However, the one tax many individuals ignore is Inheritance Tax, much to the cost of their beneficiaries. For many this tax can be reduced, or even removed completely through effective Will writing, planning ahead and the correct use of investments.

As independent financial advisers we believe that this is one area that many clients should now consider and take advantage of our free estate review service to ascertain what liability could be incurred and importantly, if so, what action can be taken to avoid the Revenue becoming a direct beneficiary of your estate.

Who Is Subject To Inheritance Tax (IHT)?

Any individual who is domiciled in the UK is potentially subject to IHT on **all** property owned whether it is located in the UK or overseas. It applies to gifts and deemed gifts made during the person's lifetime and to estates on death. The first £285,000 (current tax year 2006/07) of chargeable transfers (your estate) is free of IHT. The total of your estate valued over the current threshold is taxed at a massive 40%. For example, if an estate was valued at £400,000, on death with no provisions, a tax bill of £46,000 would be payable!

Can I Give Money Away To Reduce The Value Of My Estate?

The short answer to this is yes. You can give away any amount of capital with no immediate tax consequences. These gifts, unless they are covered by some of the exemptions below will be known as **"Potentially Exempt Transfers"** and must be an irrevocable gift with no ties or options to return the capital or asset in the future. As such, if you die after seven years of giving the gift, the value will be totally ignored when the value of your estate is calculated. However, if you die before the seven years are up, the value of the gift will be added back to your estate on a sliding scale. If you die within three years of giving the gift, the full value will be added back into your estate.

If there are strings attached when a gift is made, or the Revenue decides that you may continue to benefit from the gift, for example living in a property given to your children rent free, this will be deemed to be a **"Gift with Reservation"** and will never be out of the estate.

For the majority, giving away large sums of capital or assets is not a practical option as it is essential to ensure that you have sufficient assets to maintain your standard of living and cope with additional expenditure such as nursing home fees. Therefore, if you are considering giving money away whilst still alive, it is essential to have the option to be able to use the capital at some point if required and maintain control. This can be achieved through trusts.

There is a wide range of trusts available to suite many individual needs. Whether you are looking to establish a trust whilst alive or on death, taking advice from a specialist independent financial adviser in conjunction with your legal representatives, can allow you to build an effective inheritance tax plan to protect your hard earned savings.

Could I Pass Assets To Others With A Verbal Agreement That I Can Have The Money Back If Needed?

In theory this could be done although is a very high-risk way of reducing liability. Consider some of the following points.

- ❖ What would happen to the money if the beneficiary died?
- ❖ What would happen if the son or daughter were divorced? The assets would need to be taken into account when the divorce is settled and certain parties may not be happy to give up their right to the asset at that time?
- ❖ Giving assets will also remove any entitlement to receive state benefits?
- ❖ What if the individual lost their job or went bankrupt?

These points can show that there are a number of risks that need to be considered and your legal representative will almost certainly advise you against this action and instead suggest the use of a form of trust that would allow you to maintain full control.

Exemptions (Tax Year 2006/07)

There are a number of exemptions to this tax, some may be of use and others may not. The main ones are listed below. Exemptions allow you to give away certain amounts safe in the knowledge that they will immediately be exempt from any future tax

- ❖ Gifts to spouse - there is normally an unlimited exemption between husband and wife both during your lifetime and on death. By passing your estate between each spouse on first death, you are effectively wasting a full individual allowance of £285,000, as on the second death the whole of the estate will be assessed on one individual. It may be wise to make use of the first death allowance to pass assets to ultimate beneficiaries although through a trust that would allow the spouse use of the money until death at which time the assets would be finally released. This exemption does not currently apply to live in partners.
- ❖ Normal expenditure from income – it is possible to give regular sums providing it can be shown that they are ‘affordable’ from normal income sources. For many this is not of much use although is an important point that can be used to finance life assurance to cover potential liabilities in a very cost effective and flexible manner.
- ❖ £250 small gifts exemption - any number of individual gifts up to £250 can be given each year and be classed as exempt.
- ❖ Annual £3,000 exemption – this allows individuals to gift up to £3,000 each year. If all the annual allowance is not used, it can be rolled over for just one year. Therefore if you wish to give money away each year and have not done so before, in the current year, each individual can give £6,000 (two years allowances), and £3,000 in each future year.
- ❖ Gifts in consideration of Marriage – Each parent can give £5,000 and grand parents £2,500 to the lucky couple.
- ❖ Gifts to charities – gifts to registered charities are totally exempt with no upper limit both during your lifetime and on death.
- ❖ Gifts to political parties – are totally exempt both during your lifetime and on death but the party must have at least 2 MPs returned at the last General Election and receive more than 150,000 votes in total.

TRUSTS

What Is A Trust?

A trust is a way of ensuring that property is held for the benefit of other people without giving them full control over it. A trust can be created whilst you are alive or on death through your will. It is established where there is a transfer of assets by a person (**the settlor**) to other people (**the trustees**) who must hold and administer the gifted asset (**the trust fund**) for the benefit of specified people (**the beneficiaries**) in accordance with the terms of the trust. A few interesting points are:

- ❖ The settlor can also be one of the trustees allowing the person giving the gift to maintain control.

- ❖ The husband or wife of the settlor can be a beneficiary to allow the option to return the capital to the estate at some point in the future.

Why Use A Trust?

Trusts have an important role in financial and tax planning. You can use a trust to:

- ❖ Make gifts to individuals whether they are adults or minors. By gifting into a trust, control of these assets rests with the trustees, ensuring that they are not misused or wasted by your beneficiaries.
- ❖ Make certain that the gift reaches the person(s) you want to benefit at a time selected by you, e.g. to be gifted on your death or to assist with funding your grandchildren's education in the future.
- ❖ Help minimise your liability to IHT
- ❖ Speed up the administration of your estate and to avoid the need for probate on your death

Who Can Create A Trust?

The person who established the trust is known as **the settlor**. As the settlor, you must be over 18 years of age and of full mental capacity. A trust will normally have one settlor and more than one trustee.

Who Can Act As A Trustee?

In general any individual over 18 years of age and of full mental capacity can be a trustee. As a settlor you can be appointed as a trustee giving control over the trust fund during your lifetime. It is strongly advisable that at least two trustees are nominated and all trustees must agree any actions undertaken with the trust fund, however as the settlor nominates the trustees, it is likely that they will predominately act on the views of the settlor.

How Are Trustees Appointed Or Changed?

Trustees are appointed when the trust is established, and new or additional trustees may be appointed subsequently. Normally the power of appointment is given to the settlor in the trust provisions.

How Long Can A Trust Last?

A trust can last for up to 80 years, but may come to an end at an earlier date if all the trust fund has been distributed to beneficiaries.

Can A Trust Be Terminated?

Most Trusts are irrevocable and so cannot be cancelled. However, if all possible beneficiaries are over 18 years of age and of full capacity, then they can agree with the trustees to bring the trust to an end.

Can The Beneficiaries Be Changed?

If a trust provides absolute entitlement to benefit, beneficiaries cannot generally be changed. However, flexible trust deeds are now very common that allow the trustees to vary persons who can benefit within a defined group of potential beneficiaries and to decide the shares in which the benefits are to be held.

Can Payments Be Advanced To The Beneficiaries?

The trust may specify that the income may be used for the maintenance, education and benefit of the beneficiaries, or may give the trustees power to accumulate income at their discretion. The trust will also specify how the trustees should deal with the trust capital, and might specify that beneficiaries become entitled at a specific age, be used for a specific purpose such as education, or again leave this to the discretion of the trustees.

Can I Establish A Trust That Allows Access?

Yes. You could consider the use of a “**Flexible Loan Trust**”. In simple terms you establish a trust fund with a small gift of say £5. You then ‘loan’ a larger sum for which you retain the right to repayment on demand. Whilst the trust holds your loan, all growth on the capital is outside of your estate and therefore belongs to the beneficiaries with full control retained with the trustees of which you will be one with your spouse or family friend as the second in most circumstances. At any time you can take repayments of the loan as lump sums or a regular income. On your death the outstanding loan is returned to your estate and the balance passed to your beneficiaries, free from IHT. Over a period of time the benefits can be substantial and this is proving one of the most popular ways of managing an IHT liability.

What Type Of Investments Can I Use To Establish A Trust?

The choice of investment is most important. As with any investment you make, it must meet with your own attitude to investment potential and meet the objective for which the trust is designed. The investments can range from lower risk to actively managed funds and it is important that independent advice is taken when establishing a trust.

Do I Have To Complete Tax Return Forms For A Trust?

In many ways a trust is treated in the same way as an individual person. It has its own tax rules and allowances. If you choose to invest within tax sensitive investments such as shares, unit trusts, investments trusts, gilts, corporate bonds or cash, the trustees will need to submit a tax return each year. However, by using an investment wrapper such as an investment bond, no tax forms need to be completed whatsoever until either the trust is broken or it runs to the end of its course. For many this is the most attractive option as it can provide flexibility, a wide range of low to medium risk investments, simple administration and even further tax saving opportunities with the underlying investments. Again, it is important that independent advice is taken.

Nil Rate Band Discretionary Will Trusts

This can often be an opportunity to use the nil rate band on first death that would otherwise be wasted by transferring all assets held to the deceased’s spouse.

A discretionary trust allows a spouse to control how and when their assets are used by the children or any other beneficiaries. A discretionary nil rate band will trust is often set up by parents, who hope to provide a lump sum for their children or grandchildren, but want to defer the age at which they receive the benefit.

The nil rate band discretionary will trust is a flexible form of trust. This form of trust can be used for any number of beneficiaries and are often used when the person setting up the trust are not exactly sure of whom they want to benefit. The Nil Rate Band Discretionary Trust (NRBDT) will soak up the value of the estate up to the current nil rate band IHT allowance. Income from the trust is then typically (but not necessarily) paid to the surviving spouse for his/her lifetime.

In the past it has been common for couples to pass their share of the main home to the Discretionary Will Trust. Over recent times the Inland Revenue has considered this as a ‘Gift with Reservation’ and unless a string of conditions are met, the property will not be considered as out of the estate on second death. If this is currently written in your Wills, we strongly recommend you seek legal advice to ensure the correct measures are in place.

A typical example might be that a couple has an estate valued at £600,000 with assets split equally between them. Commonly, when the first spouse dies, the surviving spouse inherits the assets tax free, as asset transfers between spouses are not subject to IHT. In this scenario, when the surviving spouse dies, the children inherit £600,000 and must pay IHT on the sum above £285,000 excluding any growth on the assets in the interim. This equals £126,000 of tax.

A better solution, however, might be that in the wills, it is specified that a nil rate band discretionary will trust be set up and that assets to the value of the IHT threshold (currently £285,000) be passed in the discretionary will trust. The surviving spouse can still gain access to the funds held in trust for income and/or lump sums. In this situation, the family only need to find £12,000. A saving of some £114,000 in tax.

Once assets are within the trust, the original sum and any growth do not form part of the surviving spouse's estate when he/she dies. In short, a Discretionary will trust permits a spouse to redirect their inheritance into a Discretionary will trust on death although allow the surviving spouse access if required at any time. It is important to also note that as the clause is 'Discretionary' the trust is only established on first death at the discretion of the surviving spouse and is not automatic.

Including a Nil Rate Band Discretionary Trust in your will allows the decision of how much (if any) of your estate you direct to the children until after the death of the first of the parents. The existence of a NRBDT in your will doesn't mean that it has to be set up on the death of the first parent but the facility is in place as and when required.

Important Information

Information is based on Braunton IFA Ltd's interpretation and cannot be held liable for any errors or omissions. Any information is by no means implied as specific recommendations and you are strongly advised to take independent advice before proceeding with an investment or other policy and legal advice before commencing any form of trust. Past performance is no guarantee of future returns. The returns from stock market investments can rise as well as fall particularly in the short term and if you surrender early you may not get back your original investment. Your home may be repossessed if you do not keep up repayments on your mortgage.

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