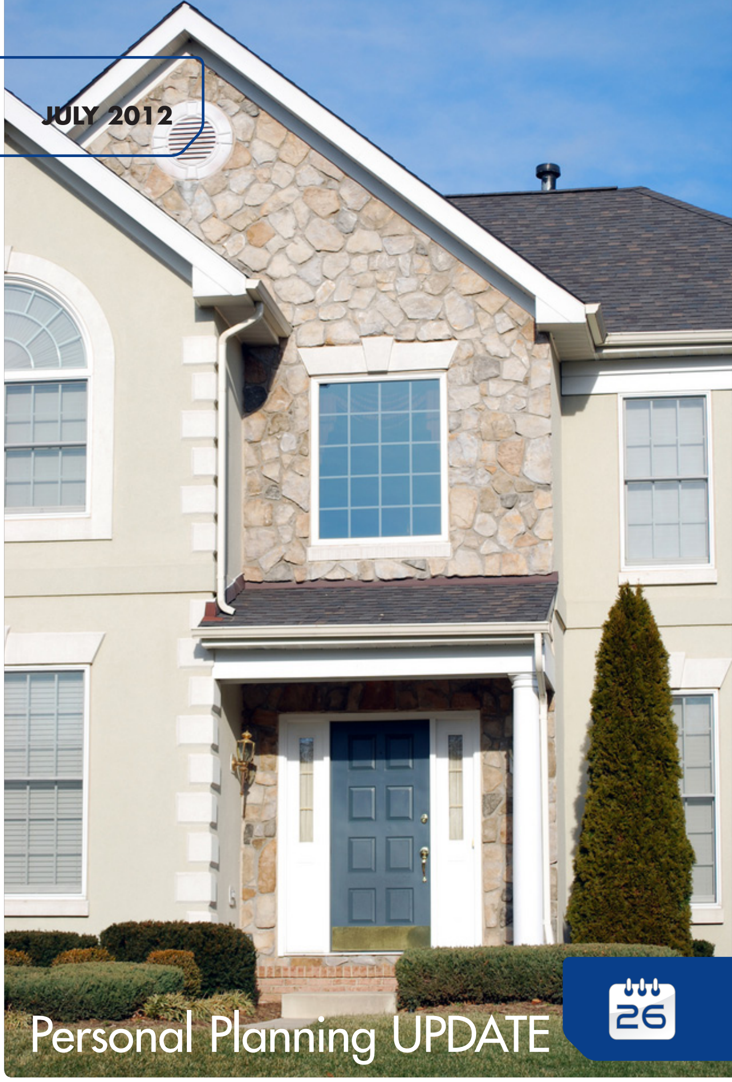

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The use of trusts in inheritance tax planning

Trusts can play an important role in inheritance tax planning, but the circumstances must be right. We take a look at the various available trusts, and when a trust may not be appropriate.

A voluntary tax?

Inheritance tax is charged at 40 per cent on the value of estates in excess of the nil rate band (NRB) of £325,000. The Government has confirmed this band will be frozen until the 2014/15 tax year. Since 6 April 2012, a reduced rate of 36 per cent is charged where 10 per cent of a person's net estate is left to charity.

Inheritance tax is sometimes called a 'voluntary tax' as there are so many ways to avoid it. These include simple measures like using the available exemptions and giving away property during your lifetime (and hopefully living for at least seven more years). There are also other opportunities available, such as business property relief and deeds of variation.

Another common method is to set up a trust. This is an arrangement where a person or people hold assets for the benefit of someone else.

It should be understood that there are many reasons for setting up a trust that are unrelated to inheritance tax. Most pension funds and many charities are trusts, for example. A trust may also be set up to provide for a child or a person lacking mental capacity.

Before looking at trusts for inheritance tax, there are two principles worth noting:

- We do not encourage artificial schemes that seek to avoid the purpose of the law. All such artificial schemes must be reported to the tax authorities who are quick to close them down.
- Tax laws change. What may be a good scheme now may not work in 20 years time when you need it.

When NOT to use a trust

A good example of the latter point above are nil rate band (NRB) trusts.

A common arrangement in a family is that a married couple leave their property to each other. If the other has already died, it usually goes to their children.

The problem with this is that transfers between husband and wife (or civil partners) are usually free of inheritance tax anyway. This means that the NRB would be wasted. If the husband died first, his estate would pass to his wife tax-free. When she died and left everything to the children, only her nil rate band could be used. The husband's nil rate band would be lost.

To avoid this, many companies marketed NRB trusts. This allowed (for example) the husband to leave to a trust a sum equal to the nil rate band for the year he died. Many of these trusts were set up and are still in existence.

However, the relevant law changed on 9 October 2007. Now, the husband's nil rate band can be added to the wife's (or vice versa). This means that an NRB trust can work *against* you.

Suppose the first death was in 1996/97 tax year. The nil rate band then was £200,000. If the wife dies now, the effect of the NRB trust is that £525,000 will be saved from tax. This is £200,000 plus the current nil rate band of £325,000.

If there had been no NRB trust, the estate would simply have two full nil rate bands, currently equal to £650,000. So another £125,000 would be spared inheritance tax. At 40 per cent that is a saving of £50,000.

The use of trusts in inheritance tax planning

On 22 March 2006, a new term was created: the relevant property trust (RPT). This included all discretionary trusts and many IIPs and A&Ms. These are now all taxed in the same way that discretionary trusts were. In other words, the tax advantages of many IIPs and A&Ms were lost.

However, some types of trust are still allowed all or some of the tax advantages that once applied to all IIPs. These trusts are:

- Assets put into an IIP trust prior to 22 March 2006
- Immediate post-death interest trust
- Transitional serial interest trust
- Disabled person's interest trust
- Trust for a bereaved minor
- Age 18 to 25 trust.

An NRB trust is usually created by a provision in the Will. If you are married or in a civil partnership and think that you have made such a provision in your Will, you may wish to speak to us about whether this should be removed.

However, the days of NRB trusts are not over. An NRB trust can still be effective if:

- A couple are not married or in a civil partnership; or
- The main asset is likely to gain significantly in value.

The latter could apply for a valuable property or a successful business. An NRB trust can be a tax shelter so that only the value when transferred into the trust is taxable. This again could work to your disadvantage, as it could mean that you pay more tax if the asset actually loses value.

Insurance

A trust is a simple way to stop life assurance proceeds being taxed.

Suppose a person insures his or her life. When the person dies the sum is added to their taxable estate. This can mean that 40 per cent of it is lost in tax. It is a straightforward matter for the life assurance policy to be written in trust so that the sum is paid directly to a beneficiary and does not form part of the estate.

Some of the more astute insurance companies already recommend this. We can check whether this has been done.

Interest in possession trusts

The law on inheritance tax and trusts changed radically on 22 March 2006. However not all Wills and trust deeds have been amended to reflect this.

An interest in possession trust (IIP) arises in cases where, for example, a surviving partner is allowed the use of property for the remainder of their life, after which the assets pass to someone else, such as their children.

IIPs were taxed more leniently than discretionary trusts as explained below.

There were also accumulation and maintenance trusts (A&M) that could be used to leave money for the benefit of children up to the age of 25. These were also taxed more leniently than discretionary trusts.

Discretionary trusts

Discretionary trusts (and all other types of relevant property trusts) give great freedom of action. The trustees may have considerable discretion in how to help the beneficiaries.

However this freedom is bought at a price.

If a large enough amount is paid into a discretionary trust, it can be liable to inheritance tax at the lifetime rate of 20 per cent. If the transferor dies within seven years, the amount can be subject to the other 20 per cent inheritance tax (possibly subject to taper relief).

In addition, there is a principal charge or periodic charge every ten years. The calculation for this charge can be complicated, but it is usually six per cent of the trust fund. Sometimes it is less.

There is a final exit charge. This is a pro rata principal charge for the period since the last principal charge.

Depending on the amount paid into a trust, these amounts of tax can be very small or very large. If you tell us what it is that you want to do, we may be able to indicate to you the amount of tax that you could be liable to pay. You can then decide if this cost justifies setting up such a trust.

Please contact us to discuss any of the issues highlighted in this guide. We can help you to decide whether a trust is applicable, and, if so, we can help you to set it up.