

# A CLIENT GUIDE: TRUST AND TAX IMPLICATIONS OF YOUR WILL

## OVERVIEW OF TRUST AND TAX IMPLICATIONS OF YOUR WILL

This is a guide to explain how inheritance tax (IHT) applies to an estate. It also details some of the more complicated trust and tax aspects of the provisions in your will though not all of the sections of this guide may apply to your will. The will commentary that accompanies this guide refers you to the relevant sections.

This guide outlines the current law relating to trusts and IHT at the date we send it to you. Our advice is based on the law as generally understood and takes into account accepted HMRC practice, interpretation, press releases and practice statements. HMRC may change these without warning you first and, generally, may announce changes to IHT and the taxation of trusts at any time.

It is very important to review your will and the value of your assets:

- At regular intervals or at least every five years.
- Whenever there is a significant change in your circumstances.

## IHT SUMMARY

### *What is IHT?*

IHT is primarily a charge on your assets on death, including your share of assets jointly held with others. Lifetime gifts made in the seven years before your death can also be brought back into account.

IHT is also charged where an asset appears to have been given away but where, in fact, you retain the use of that asset.

### *IHT, nil rate band and residence nil rate band*

When you die, the IHT charge on your estate is at 0% on the nil rate band and at 40% on the remaining balance.

The nil rate band is currently £325,000 and is set at that level until 5 April 2021. However, the nil rate band available on your death can vary as it can be used up by lifetime gifts made in the seven years before your death.

If you are married or in a civil partnership, your surviving spouse or civil partner can inherit the unused portion of your nil rate band on their subsequent death, to reduce the IHT payable on their estate. This claim is for the unused percentage, rather than the value of the unused amount at the time.

If you give your home to direct descendants such as children and grandchildren or certain other beneficiaries, from 6 April 2017 your estate can benefit from an additional residence nil rate band (RNRB). The other beneficiaries include adopted children,

stepchildren and foster children, as well as the spouses and civil partners of all these beneficiaries. The RNRB may also be available if you sell your home and buy a less valuable property, or cease to own a property, and any part of your estate passes to these beneficiaries (this is known as a downsizing addition).

If the RNRB applies, between a further £100,000 to £175,000 of the estate could be taxed at 0%. You can also transfer unused RNRB from a deceased spouse or civil partner. However, the RNRB of each individual is tapered if the value of their estate (before applying any IHT exemptions and reliefs) exceeds £2 million. This limit may change after 5 April 2021. Currently, the taper means that an estate worth more than £2.2 million cannot benefit from the RNRB.

### *Main exemptions for lifetime gifts and on death*

Certain gifts are exempt from IHT and do not use up your nil rate band. The main exemptions are:

- Gifts to your spouse or civil partner (the spouse exemption).
- Gifts to charities established in the UK (the charity exemption).
- Gifts made regularly out of surplus income.

There is an important restriction on the spouse exemption where a UK domiciled person leaves assets to their non-UK domiciled spouse or civil partner. If you think that this may apply to you, please ask us.

### *Potentially exempt transfers (PETs)*

An outright gift to an individual is potentially exempt from IHT and becomes fully exempt if you survive for seven years from the date of the gift. If you do not survive for seven years, the gift becomes chargeable to IHT, but will be taxed at 0% if its value falls within your nil rate band. Even if IHT does become payable, the longer you survive after making the gift (subject to surviving at least three years), the lower the IHT charge on the gift on a sliding scale. The charge is reduced by 20% for each year that you survive after the third year, with a maximum 80% reduction if you survive for between six and seven years.

### *Domicile*

If you are domiciled in the UK, you are subject to IHT on your worldwide assets. If you are domiciled outside the UK, you are only subject to IHT on your UK assets. Domicile has a specific legal meaning for UK tax purposes, beyond the simple dictionary definition of place of residence. You may acquire a UK deemed domicile for IHT if you have lived in the UK for a long time. If you are unclear about your domicile status, we can look into this in more detail for you.

### **Where does the burden of IHT fall?**

Where the burden of IHT falls, that is which assets may be used to pay the IHT, depends on what is in your estate when you die and the provisions of your will.

## **TRUST SUMMARY**

You may have established a trust in your will to govern how your beneficiaries enjoy the benefit from your assets after you die. A trust arises whenever you give your assets to another person (the trustee) to hold for the benefit of someone else (the beneficiary).

### **Trustees' duties**

Trustees have various duties, including:

- Balancing the competing interests of all beneficiaries of the trust (this can be particularly difficult between beneficiaries of income and capital).
- Investing the trust assets carefully after taking professional investment advice.
- Completing and submitting annual self-assessment tax returns for the income and capital gains of the trust.
- For discretionary trusts, completing and submitting supplementary tax returns whenever an IHT charge arises (see Discretionary trust).
- Running the trust properly, including holding regular meetings to decide what to do with the income and capital in the trust in any one tax year.
- Keeping a full record of the decisions taken in trustee meetings.

Three main types of trust that may arise in your will are:

### **Life interest trust**

In a life interest trust, the entitlement to an asset is split into its capital and income elements. For example, if the asset is a share in a company, the capital is the share and the income is the dividend that is paid out on the share. The beneficiary entitled to the income is called the life tenant and when the entitlement to income ends, the capital then passes to the beneficiaries you specify. The life tenant is treated for IHT purposes as if they own the trust assets so that when the life tenant dies, under a will trust, the assets in the life interest trust are treated as though they were part of the life tenant's estate.

### **Discretionary trust**

In a discretionary trust, although the capital and income elements of the assets are still important, the trustees can distribute income and capital separately to beneficiaries, as the trustees think fit. There are usually several beneficiaries (specified in your will) who may potentially benefit from the assets in the trust, but no beneficiary is absolutely entitled to either income or capital unless (or until) the trustees do something to create such an entitlement.

### **Bare trust**

In a bare trust, the beneficiary has an absolute entitlement to the assets, but the trustee holds the assets on the beneficiary's behalf. This kind of trust arises, for example, where your will makes a gift to a beneficiary who is under the age of 18. The trustees, therefore, hold the assets until the beneficiary can give a valid receipt for them.

## **YOUR WILL: GENERAL PRINCIPLES**

### **Tax-efficient wills for spouses or civil partners**

Often, one of the primary intentions behind the provisions in a will is to ensure that no IHT is payable when a spouse or civil partner dies. If that is your intention, you must make sure you restrict, to an amount less than the nil rate band, the total value of gifts in your will (or in the seven years before your death) to non-exempt beneficiaries. A gift to your spouse, civil partner or to a charity is exempt. A gift to your children and grandchildren is not exempt, but it may enable the RNRB to be claimed (see IHT, nil rate band and residence nil rate band). You can say in your will that a gift of a specific asset, such as personal possessions, cash or a property is subject to IHT. This means that the proportion of tax due on that gift must be paid from the gift.

For example, if you give £5,000 to your son subject to IHT, a proportion of the IHT payable on your death must come out of that cash gift so that your son will receive the gift net of tax.

### **IHT on non-residuary gifts**

A non-residuary gift is any gift other than the main provisions dealing with your residuary estate, including:

- Gifts of personal possessions.
- Gifts of money.
- Gifts or trusts of real property.
- A gift or trust of a "nil rate amount" (that is, the maximum amount you can give free of IHT).

Unless these gifts specifically state otherwise, any IHT payable on the assets given in your will is payable from your residuary estate.

## **GIFTS OF PERSONAL POSSESSIONS**

### **Outright gifts**

The beneficiary is entitled to the assets from the outset and can deal with them as they think fit. The assets form part of the beneficiary's estate for tax purposes.

### **Gifts with a request to distribute**

The beneficiary is entitled to the assets from the outset. However, if (within two years of your death) the beneficiary passes any asset on in accordance with any wishes you make known, the onward gift is treated as though it was made by you in your will (and not by the original beneficiary). Any assets not distributed in this way form part of the original beneficiary's estate for tax purposes.

### **Tax treatment of gifts**

The gift is exempt from IHT if the beneficiary of this gift is your spouse or civil partner, or a charity. However, any onward gifts of those personal possessions by your spouse or civil partner in accordance with a request to distribute are treated, for IHT purposes, as if made in your will and the benefit of the IHT exemption is accordingly lost.

If the beneficiary is a non-exempt beneficiary (such as a child or grandchild), the nil rate band available to your estate is reduced by the value of the gift and your estate may be subject to IHT if the nil rate band is all used up.

## GIFT OF REAL PROPERTY

### ***Tax treatment of the gift***

The gift is exempt from IHT if the beneficiary is your spouse or civil partner, or a charity.

If the beneficiary is your direct descendant or any of the other qualifying beneficiaries mentioned above, the gift is not exempt but the RNRB may be available.

If the beneficiary is a non-exempt beneficiary, the nil rate band available to your estate is reduced by the value of the gift that exceeds any RNRB and your estate may be subject to IHT if the nil rate band is all used up.

### ***Trust of real property: tax treatment***

The property and any assets arising from it are treated for tax purposes as though they belong to the life tenant.

### ***When life interest trust comes into effect***

If the life tenant is your spouse or civil partner, the spouse exemption applies to exempt the value of the property from IHT on your death.

If the life tenant is your direct descendant or any of the other qualifying beneficiaries mentioned above, the gift is not exempt but the RNRB may be available.

If the life tenant is a non-exempt beneficiary, there is no exemption and the nil rate band available to your estate is reduced by the value of the property that exceeds any RNRB so that IHT is payable if the nil rate band is all used up.

### ***When life interest trust comes to an end***

If the life interest trust comes to an end on the life tenant's death, the value of the assets in this trust are treated as forming part of the life tenant's own estate for IHT purposes and are taxed accordingly. For example, the RNRB may be available if the assets pass to the life tenant's own direct descendants or other qualifying beneficiaries at that time.

If the life interest trust comes to an end while the life tenant is still alive, the life tenant is treated as making a gift of the assets in the trust. The tax treatment of that gift depends on the eventual beneficiaries of the trust assets, as follows:

- If the assets pass outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT.
- If the assets pass outright to non-exempt beneficiaries (such as your children or grandchildren), the gift is treated as a PET by the life tenant (see Potentially exempt transfers (PETs)).
- If the assets pass into a trust (either another life interest or a discretionary trust), the life tenant's estate is charged to IHT at the lifetime rate of 20%, to the extent that the value exceeds the life tenant's own available nil rate band.

### ***Right to occupy real property: tax treatment***

The right to occupy does not include any right to income arising from the property or its sale proceeds. However, the property is treated for tax purposes as though it belongs to the occupier.

### ***When right to occupy comes into effect***

If the occupier is your spouse or civil partner, HMRC should treat the occupier as having a life interest and so the spouse exemption applies to exempt the value of the property from IHT.

If the occupier is your direct descendant or any of the other qualifying beneficiaries mentioned above, the gift is not exempt

but the RNRB may be available.

If the occupier is a non-exempt beneficiary, there is no exemption and the nil rate band available to your estate is reduced by the value of the property that exceeds any RNRB.

### ***When right to occupy comes to an end***

If the right to occupy comes to an end on the occupier's death, the value of the property is treated as forming part of the occupier's own estate for IHT purposes and is taxed accordingly. For example, the RNRB may be available if the assets pass to the occupier's own direct descendants or other qualifying beneficiaries at that time.

If the right to occupy comes to an end in any other circumstances, the occupier is treated as having made a gift of the property. The tax treatment of that gift depends on the eventual beneficiaries of the property, as follows:

- If the property passes outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT.
- If the property passes outright to non-exempt beneficiaries (for example, your children or grandchildren), the gift is treated as a PET by the occupier.
- If the property passes into a trust (either life interest trust or discretionary trust), the occupier's estate is charged to IHT at the lifetime rate of 20%, to the extent that the value exceeds the occupier's own available nil rate band.

## GIFTS OF MONEY

### ***Beneficiaries under 18 years old***

If you make a gift of money to a beneficiary who is under 18 years old when you die, the beneficiary is legally entitled to the income (although your trustees can hold it in a separate account for the beneficiary until they reach 18). The tax treatment while the beneficiary is under 18 is as follows:

- **Income tax.** The income is taxed as the beneficiary's income, with the benefit of the beneficiary's personal allowance and at the rates of tax that apply to them.
- **IHT.** This clause is drafted so that there is no additional IHT to pay unless the beneficiary dies before reaching 18 (in which case there is a potential IHT liability on the value of the beneficiary's personal estate including the cash gift).

### ***Gift of the nil rate amount***

This gift is made conditional on an IHT-exempt beneficiary (spouse, civil partner or a charity) inheriting your residuary estate, as there is no IHT-efficiency achieved by this type of gift otherwise. The gift is worded so that if your spouse or civil partner has already died, it does not take effect at all.

As the amount of your available nil rate band and any RNRB is likely to vary after you make your will, your will defines the nil rate amount, broadly as the largest amount of cash you can give in your will without paying IHT.

### ***Reducing value of your gift***

The value of this gift is reduced by:

- All of the non-residuary gifts made in your will to non-exempt beneficiaries.
- Any gifts made by you before your death where their value must be taken into account for IHT purposes (usually gifts made in the seven years before your death).

### ***Increasing value of your gift***

Depending on how the clause is drafted, the value of your gift may be increased by:

- Any transferable nil rate band from a deceased spouse or civil partner.
- Any RNRB, including any downsizing addition or RNRB transferred from a deceased spouse or civil partner.
- A proportion of the value of IHT relief given to assets in your estate that qualifies for agricultural or business property relief. (The application and interaction of these reliefs with the rest of your estate is very complex and beyond the scope of this guide. If you would like a more detailed explanation of the rules, please ask us.)

The beneficiary is entitled to the assets from the outset and can deal with them as they think fit. The assets form part of the beneficiary's estate for tax purposes. This is a much less flexible form of gift than a discretionary trust.

### ***Trust of the nil rate amount: tax treatment***

This gift is made conditional on an IHT-exempt beneficiary (spouse, civil partner or a charity) inheriting your residuary estate. This means that where a will leaves the residuary estate to a spouse or civil partner and they die before you, this gift does not take effect at all. If you are planning to leave your residuary estate to a non-exempt beneficiary (such as a child or grandchild), do not use the nil rate band trust as it is not tax efficient.

Your trustees have various duties (see Trust summary).

### ***When the trust comes into effect***

As the value of the gift is the maximum gift of cash that you can give away without needing to pay IHT, there is no IHT to pay when the trust comes into effect.

### ***During the trust period***

In the two-year period following your death, your trustees can take advantage of some writing-back provisions to make payments out of the trust and for these to be treated, for IHT purposes, as though they were gifts made by you on your death. These provisions can be particularly useful for tax and succession planning, as your trustees can take account of all surrounding circumstances during that two-year period (including the relative financial and personal situations of all potential beneficiaries).

Discretionary trusts are subject to two additional types of IHT charge during their existence, at a maximum rate of 6% as follows:

- **Exit charges.** These charges apply when property leaves the trust.
- **Ten-year anniversary charges.** These charges apply every ten years after your death. The amount of the charge is broadly based on the value of assets in the trust on the ten-year anniversary, any assets left the trust in the preceding ten years and the nil rate band that is applicable on the anniversary date.

## **RESIDUARY ESTATE**

### ***Outright gift to your spouse or civil partner***

Your spouse or civil partner is entitled to the residuary estate and can deal with it as they think fit. The assets in the residuary estate form part of their estate for tax purposes.

The spouse exemption applies to the gift and there is no IHT to pay on the residuary estate.

### ***Trust for your spouse or civil partner: tax treatment***

The assets in the residuary estate are treated for tax purposes as though they belong to the life tenant. This happens:

- **When life interest trust comes into effect.** Because the life tenant is your spouse or civil partner, the spouse exemption applies to exempt the value of the residuary estate from IHT.
- **When life interest trust comes to end.** If the life interest trust comes to an end on the life tenant's death, the assets in this trust are treated as forming part of the life tenant's estate for IHT purposes and are taxed accordingly. For example, the RNRB may be available if the assets pass to the life tenant's own direct descendants or other qualifying beneficiaries at that time. If the life interest trust comes to an end while the life tenant is still alive, the life tenant is treated as making a gift of the assets in the trust. The tax treatment of that gift depends on the eventual beneficiaries of the trust assets:
  - if the assets pass outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT;
  - if the assets pass outright to non-exempt beneficiaries (for example, your children or grandchildren), the gift is treated as a PET by the life tenant; and
  - if the assets pass into another trust (either another life interest or a discretionary trust), the life tenant's estate is charged to IHT at the lifetime rate of 20%, where the value exceeds the life tenant's own available nil rate band.

### ***Discretionary trust: tax treatment***

IHT may become due:

- **When trust comes into effect.** IHT is paid on any assets forming part of the residuary estate over the nil rate band and RNRB.
- **During the trust period.** In the two-year period following your death, your trustees can take advantage of some writing-back provisions to make payments out of the trust and to have these treated for IHT purposes as though they were gifts made by you on your death. These provisions can be particularly useful for tax and succession planning, as your trustees can take account of all surrounding circumstances during that two-year period (including the relative financial and personal situations of all potential beneficiaries). Discretionary trusts are subject to two additional types of IHT charge during their existence, at the rate of 6% as follows:
  - **Exit charges.** These charges apply when property leaves the trust.
  - **Ten-year anniversary charges.** These charges apply every ten years after your death. The amount of the charge is broadly based on the value of assets in the trust on the ten-year anniversary, any assets that leave the trust in the preceding ten years and the nil rate band that is applicable on the anniversary date.

### **Outright gifts to beneficiaries under 18 years old: tax treatment**

If you make an outright gift to a beneficiary who is under 18 when you die, the beneficiary is legally entitled to the income (although your trustees can hold it in a separate account for them until they reach 18). The tax treatment while the beneficiary is under 18 is as follows:

- **Income tax.** The income is taxed as the beneficiary's income, with the benefit of the beneficiary's personal allowance and at the rates of tax that apply to them.
- **IHT.** IHT is paid on any assets forming part of the residuary estate over the nil rate band and RNRB. The RNRB may be available because your children are qualifying beneficiaries (see IHT, nil rate band and residence nil rate band). There is no additional IHT to pay unless the beneficiary dies before reaching 18 (in which case there is a potential IHT liability on the value of the beneficiary's personal estate including the gift).

### **Trusts for your children at 18 years**

Your trustees have various duties (see Trust summary).

If your children are already over 18 when you die, they are entitled to the assets and no trusts arise. The IHT treatment while your children are under 18 is as follows:

- **When the trust comes into effect.** IHT is paid on any assets forming part of the residuary estate over the nil rate band and RNRB. The RNRB may be available because your children are qualifying beneficiaries (see IHT, nil rate band and residence nil rate band).
- **During the trust period.** There is no additional charge to IHT if a child survives to 18. However, if a child dies before the age of 18 leaving a child (your grandchild), that grandchild takes the share of the deceased parent. If this happens, the grandchild's share may attract IHT from time to time and when the trust ends.

### **Trusts for your children between 18 and 25 years**

Your trustees have various duties (see Trust summary).

The tax rules for this type of trust are very complicated and you should not hesitate to discuss them further with us if you wish to. In general terms, the trust functions as follows:

- IHT is paid on any assets forming part of the residuary estate over the nil rate band and RNRB. The RNRB may be available because your children are qualifying beneficiaries (see IHT, nil rate band and residence nil rate band).
- If your children are already over 25 when you die, they are entitled to the assets and no trusts arise.
- If your children have not reached 25 when you die, if the children receive their share of the estate no later than the age of 18, no additional IHT charges arise.
- If your children only take their share later (at any age up to 25), IHT charges may arise once the child turns 18. For example, the child takes their share at age 21. In this case, there is three years' worth of tax to pay when he does so (from age 18 to age 21) that is payable when the child turns 21 and takes their share.
- Bear in mind that at current levels, the rate of tax is low. In the worst-case scenario, the tax rate when inheriting at age 21 is 1.8%, which is charged on the value of the property that the child takes at 21. In most cases, however, the rate is less than that.

- There may be good reasons why you do not wish your children to inherit at 18. However, for maximum flexibility, your will gives your trustees power to pay out the children's shares early. If your trustees paid the shares out to children aged 18 or under, the IHT charge would be avoided altogether, which could be particularly useful if tax rates were to rise in the future.

You should also consider and bear in mind the following:

- If you wish to delay a child taking their share until an age later than 25, you should discuss this with us, as the IHT treatment is different.
- Your will provides that, if a child dies before taking their share and leaves a child (your grandchild), that grandchild takes the share of the deceased parent. If this happens, the grandchild's share may attract IHT from time to time and when the trust ends. The rates of tax are relatively low and your will gives your trustees the necessary powers to end the trust early, if appropriate.

### **Life interest trusts for children or grandchildren**

Your trustees have various duties (see Trust summary).

The assets in the residuary estate are treated for tax purposes as though they belong to the life tenants, in equal shares.

This happens:

- **When life interest trust comes into effect.** IHT is paid on any assets forming part of the residuary estate over the nil rate band and RNRB. The RNRB may be available because your children and grandchildren are qualifying beneficiaries (see IHT, nil rate band and residence nil rate band).
- **When life interest trust comes to end.** If a life interest trust comes to an end on a life tenant's death, the assets in the trust are treated as forming part of the life tenant's estate for IHT purposes and are taxed accordingly. For example, the RNRB may be available if the assets pass to the life tenant's direct own descendants or other qualifying beneficiaries at that time. If the life interest trust comes to an end while the life tenant is still alive, the life tenant is treated as making a gift of the assets in the trust. The tax treatment of that gift depends on the eventual beneficiaries of the trust assets:
  - if the assets pass outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT;
  - if the assets pass outright to non-exempt beneficiaries (for example, the life tenant's children or grandchildren), the gift is treated as a PET by the life tenant; and
  - if the assets pass into another trust (either another life interest or a discretionary trust), the life tenant's estate is charged to IHT at the lifetime rate of 20%, where the value exceeds the life tenant's own available nil rate band.

### **Default gift of the trust fund**

Gifts to named or class beneficiaries attract IHT on any assets forming part of the residuary estate over the nil rate band and RNRB. The RNRB may be available if the beneficiaries are qualifying beneficiaries. If a beneficiary dies before taking their share and leaves a child, that child takes the share of the deceased parent. If this happens, the child's share may attract additional IHT from time to time and when the trust ends.

Gifts to named charities are exempt from IHT.

## WORDS USED IN THIS NOTE

**Estate:** everything that belonged to a person who has died and all the person's debts.

**Residuary estate:** the rest of a deceased person's estate that is left after the payment of specific gifts, debts, funeral expenses and inheritance tax.

**Real property:** all land and anything that is firmly attached or integrated, as well as all interests associated with the land.

**Agricultural property relief:** a relief from inheritance tax. When the conditions for the relief are met, it reduces the agricultural value of any gifts of agricultural property made in a person's lifetime or on death.

**Business property relief:** a relief from inheritance tax for certain shareholdings, interests in a business or assets used by the owner's business. When the conditions for the relief are met, it reduces the value transferred by a gift made during a person's lifetime or on death.



If you have any questions, please feel free to get in touch :-)

*Ella Millett*