

Nil Rate Band Discretionary Trust – an explanation

Due to the increase in property prices and the wealth of people generally Trusts are being used more regularly in order to mitigate the payment of inheritance tax.

Married couples who have joint assets worth in excess of currently £300,000*, ('the nil rate band') should review their Wills to make them 'tax efficient'. Most couples leave their estates to each other and then, on second death, to their children. This type of arrangement, although common, is not tax efficient. Although the spouse exemption means that no inheritance tax is charged on first death, on the second death the liability to inheritance tax could be substantial thereby reducing the amount available for distribution between the children.

Many couples fail to use the nil-rate 'tax free' band on first death to reduce the inheritance tax payable on second death. In order to make use of the nil rate band married couples and same sex couples who have entered into a Civil Partnership Agreement should consider the possibility of using Nil Rate Band Discretionary Trusts in their Wills.

We suggest that spouses make Wills including a legacy on Discretionary Trusts of the nil-rate band and gift the remainder to the surviving spouse either absolutely or for life. Certain gifts may, however, reduce the amount of the Nil Rate Band available if you die within seven years of making the gift.

The legacy of the nil rate band will be subject to a Discretionary Trust. This means that the Trustees (who can be the surviving spouse and others) are given power, at their discretion, to pay the income arising from the assets held on trust to any member of a group of beneficiaries named in the Will. The Trustees also have the power to advance capital if necessary. The beneficiaries are set out in the Will and normally include the surviving spouse, children and grandchildren.

As the Trust is Discretionary, it is flexible in nature and the Trustees have complete discretion about who benefits from the monies entrusted to them and, although their decision must be unanimous, it is important to choose the Trustees carefully.

The Trust can be funded by way of cash or assets – including making use of a share of the matrimonial home but this would be determined when one of our Trusts and Probate team assesses the situation and fully explains the available options to you.

If the Trust is set up correctly then no Inheritance tax will be payable on the death of the first spouse so long as the gift to the Trust does not exceed the nil-rate band. As the Trust is discretionary in nature whilst the surviving spouse is a potential beneficiary any benefit for the spouse is not guaranteed so the amount in the Trust will not be added to the estate of the surviving spouse upon their death.

In an ideal situation the maximum tax saving of £120,000 should be achieved i.e. 40% of £300,000.

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The most important aspect of such an arrangement is, however, to ensure that a balance is achieved between making use of the tax free band on the first death and diminishing the funds available to the surviving spouse.

When funds are distributed from the Trust to a beneficiary, and on each ten year anniversary of the creation of the Trust, there may be a charge to Inheritance Tax. However, the Trust itself has it's own nil-rate band. If the value of the Trust exceeds the nil rate band a tax charge may result but the tax will not normally be significant.

Income of the Trust is taxed at the additional rate applicable to Trusts but if a beneficiary to whom income is distributed is not a higher rate tax payer then a rebate may be payable.

It is important to remember that tax legislation changes and that this type of tax planning is likely to be reviewed but Wills should also be reviewed!

Please see the press release entitled 'Inheritance tax concerns over recent ruling', issued in April 2007 regarding the case of Dr Phizackerley.

* This figure will increase to £312,000 with effect from 06.04.08
to £325,000 with effect from 06.04.09
to £350,000 with effect from 06.04.10

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<p>The contents of this sheet is for information only. You should never act on the contents of the information sheet alone, and should always seek professional legal advice regarding to your particular situation before taking any action. Information updated October 2007.</p>
