



# INHERITANCE TAX & ESTATE PLANNING

The future can't be predicted  
but it can be protected



THE £327BN BEING HANDED DOWN OVER THE NEXT TEN YEARS EXCEEDS THE £274BN CURRENTLY ADMINISTERED ON BEHALF OF UK PRIVATE CLIENTS<sup>[1]</sup>. THE SHEER SCALE OF FORTHCOMING INHERITANCE DEMONSTRATES THE RISING IMPORTANCE OF WEALTH TRANSFER.

[1] Brooks MacDonald, April 2021

# WELCOME

Welcome to our Inheritance Tax & Estate Planning Guide.

When you've worked hard and invested carefully to build your wealth, you want to look after it. That's why it's important to plan for your wealth preservation and the eventual transfer of that wealth.

Have you considered this question: 'What will happen to my estate when I've gone?' Wealth preservation and wealth transfer are becoming an increasingly important issue for many families today. Individuals with assets of any size should seek professional financial advice to consider what action may need to be taken before it's too late.

The reality is, most of us should prepare for the eventual transfer of our assets, regardless of any tax or legal consequences. It is natural that many of us want to leave our wealth to those who matter the most. Having a well-managed estate can save time and legal costs in the long term, help avoid a large Inheritance Tax bill, and cushion the blow for those you leave behind.

It's important to start with a clear picture of your goals. You may want your estate to provide ongoing income and security for dependants, to make bequests or to set up Trusts. Everyone's circumstances are different – planning can look at tax-efficiency and maintaining access to income and capital.

It can also include protection from irresponsible beneficiaries, or to provide for vulnerable or minor (those under 18) beneficiaries. We can also help you assess and minimise any risk to your inherited assets, for example from divorce or bankruptcy.

Wealth preservation and the transfer of your wealth is not just for the super-rich. It is essential for anyone who wants to ensure that their loved ones benefit from their inheritance and are not burdened by it.

|   |    |
|---|----|
| Inheritance Tax (IHT).....                          | 04 |
| Inheritance Tax Residence Nil-Rate Band (RNRB)..... | 06 |
| Lifetime transfers.....                             | 08 |
| Trusts.....   | 10 |
| Bare Trust.....                                     | 11 |
| Discretionary Trust.....                            | 12 |
| Flexible Trusts with default beneficiaries.....     | 14 |
| Split Trusts.....                                   | 15 |
| Protecting your assets for the next generation..... | 16 |

TRUSTS ARE A HIGHLY COMPLEX AREA OF FINANCIAL PLANNING.  
PROFESSIONAL ADVICE SHOULD BE OBTAINED BEFORE TAKING ANY ACTION.

This guide is for your general information and use only and is not intended to address your particular requirements. It should not be relied upon in its entirety and shall not be deemed to be, or constitute, advice. Although endeavours have been made to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No individual or company should act upon such information without receiving appropriate professional advice after a thorough examination of their particular situation. We cannot accept responsibility for any loss as a result of acts or omissions taken in respect of any articles. Thresholds, percentage rates and tax legislation may change in subsequent Finance Acts.

# INHERITANCE TAX

Don't leave less money behind for your loved ones.

Effective estate preservation planning could save a family a potential Inheritance Tax bill amounting to hundreds of thousands of pounds. Inheritance Tax was introduced in 1986. It replaced Capital Transfer Tax, which had been in force since 1975 as a successor to Estate Duty.

Inheritance Tax planning has become more important than ever, following the Government's decision to freeze the £325,000 lifetime exemption until 2026, with inflation eroding its value and subjecting more families to Inheritance Tax

## Automatic rights

Inheritance Tax is usually payable on death. When a person dies, their assets form their estate. Any part of an estate that is left to a spouse or registered civil partner will be exempt from Inheritance Tax. The exception is if a spouse or registered civil partner is domiciled outside the UK. Unmarried partners, no matter how long-standing, have no automatic rights under the Inheritance Tax rules.

However, there are steps people can take to reduce the amount of money their Beneficiaries have to pay if Inheritance Tax affects them. Where a person's estate is left to someone other than a spouse or registered civil partner (i.e. to a non-exempt beneficiary), Inheritance Tax will be payable on the amount that exceeds the £325,000 Nil-Rate Band (NRB) threshold. The threshold is currently

frozen at £325,000 until the tax year 2025/26.

## Deceased spouse

Every individual is entitled to a NRB (that is, every individual is entitled to leave an amount of their estate up to the value of the NRB threshold to a non-exempt beneficiary without incurring Inheritance Tax). If a widow or widower of the deceased spouse has not used their entire NRB, the NRB applicable at the time of death can be increased by the percentage of the NRB unused on the death of the deceased spouse, provided the executors make the necessary elections within two years of your death.

To calculate the total amount of Inheritance Tax payable on a person's death, gifts made during their lifetime that are not exempt transfers must also be taken into account.

Where the total amount of non-exempt gifts made within seven years of death plus the value of the element of the estate left to non-exempt beneficiaries exceeds the nil-rate threshold, Inheritance Tax is payable at 40% on the amount exceeding the threshold.

## Tapered away

This percentage reduces to 36% if the estate qualifies for a reduced rate as a result of a charity bequest. In some circumstances, Inheritance Tax can also become payable on the lifetime gifts themselves – although

gifts made between three and seven years before death could qualify for taper relief, which reduces the amount of Inheritance Tax payable.

From 6 April 2017, an Inheritance Tax Residence Nil-Rate Band (RNRB) was introduced in addition to the standard NRB. It's worth currently up to £175,000. It starts to be tapered away if an Inheritance Tax estate is worth over £2 million on death.

## Residential property

Unlike the standard NRB, it's only available for transfers on death. It's normally available if a person leaves a residential property that they've occupied as their home outright to direct descendants.

It might also apply if the person sold their home or downsized from 8 July 2015 onwards. If spouses or registered civil partners don't use the RNRB on first death – even if this was before 6 April 2017 – there are transferability options on the second death.

## Personal representatives

Executors or legal personal representatives typically have six months from the end of the month of death to pay any Inheritance Tax due. The estate can't pay out to the beneficiaries until this is done. The exception is any property, land or certain types of shares where the Inheritance Tax can be paid in instalments. Beneficiaries then have up to ten years to pay the tax owing, plus interest.

IHT RECEIPTS WERE £7.1BN  
DURING THE FINANCIAL  
YEAR 2022/23, THE HIGHEST  
LEVEL ON RECORD SO FAR. <sup>[2]</sup>



[2] [Statista.com IHT receipts in the UK 2022/23](https://www.statista.com/statistics/1101114/inheritance-tax-receipts-in-the-uk-2022-23/)

# INHERITANCE TAX RESIDENCE NIL-RATE BAND

Passing on your wealth in the right way is key for its preservation.

The rise in property prices throughout the UK means that even those with modest assets may exceed the £325,000 Nil-Rate Band (NRB) for Inheritance Tax. On 6 April 2017 the Residence Nil-Rate Band (RNRB) band came into effect. It provides an additional nil-rate band where an individual dies after 6 April 2017, owning a residence which they leave to direct descendants

Currently, the maximum RNRB available is £175,000. Just like the standard NRB, any unused RNRB on the first death of a married couple or registered civil partners has the potential to be transferable even if the first death occurred before 6 April 2017. However, the RNRB does come with conditions and so may not be available or available in full to everyone.

## Taxable estate

The RNRB is set against the taxable value of the deceased's estate – not just the value of the property. Unlike the existing NRB, it doesn't apply to transfers made during an individual's lifetime. For married couples and registered civil partners, any unused RNRB can be claimed by the surviving spouses or registered civil partner's personal representatives to provide a reduction against their taxable estate.

Where an estate is valued at more than £2 million, the RNRB will be progressively reduced by £1 for every £2 that the value of the estate exceeds the threshold. Special provisions apply where an individual has downsized to a lower value

property or no longer owns a home when they die.

## Lifetime gifts

In determining whether the £2 million threshold is breached, it is necessary to ignore reliefs and exemptions. This means that business relief and agricultural relief are ignored when determining the value of the estate for the RNRB even though they are taken into account to calculate the liability to Inheritance Tax.

As the £2 million is based on the value of the assets owned at the time of death, it does not include any lifetime gifts made by the deceased, even if they were made within seven years of death and are included in the Inheritance Tax calculation.

## Direct descendants

The £2 million threshold is frozen up to and including 2025/26, after which, like the standard NRB and Inheritance Tax RNRB, it will increase in line with CPI. Based on a RNRB figure of £175,000, estates of £2.35 million or greater will not benefit from an RNRB.

The amount of RNRB available to be set against an estate will be the lower of the value of the home, or share, that's inherited by direct descendants and the maximum RNRB available when the individual died.

## Deceased spouse

Where the value of the property is lower than the maximum RNRB,

the unused allowance can't be offset against other assets in the estate but can be transferred to a deceased spouse or registered civil partner's estate when they die, having left a residence to their direct descendants.

A surviving spouse or registered civil partner's personal representatives may claim any unused RNRB available from the estate of the first spouse or registered civil partner to die.

## Residential interest

This is subject to the second death occurring on or after 6 April 2017 and the survivor passing a residence they own to their direct descendants. This can be any home they've lived in – there's no requirement for them to have owned or inherited it from their late spouse or registered civil partner.

In order to pass on a qualifying residential interest and use the Inheritance Tax RNRB, the property needs to be 'closely inherited'. This means that the property must be passed to direct descendants.

## Special guardian

For these purposes, direct descendants are lineal descendants of the deceased – children, grandchildren and any remoter descendants together with their spouses or registered civil partners, including their widow, widower or surviving registered civil partner. Also included are a step, adopted or fostered child of the deceased, or a child to which the deceased was



appointed as a guardian or a special guardian when the child was under 18.

Direct descendant doesn't include nephews, nieces, siblings and other relatives. If an individual, a married couple or registered civil partners do not have any direct descendants that qualify, they will be unable to use the RNRB.

#### **Deemed residence**

The facility to claim unused RNRB applies regardless of when the first death occurred – if this was before it was introduced, then 100% of a deemed RNRB of £175,000 can be claimed, unless the value of the first spouse or registered civil partner's estate exceeded £2 million and tapering of the RNRB applies.

The unused RNRB is represented as a percentage of the maximum RNRB that was available on first death – meaning the amount available against the survivor's estate will benefit from subsequent increases in the RNRB.

#### **Deed of variation**

The transferable amount is capped at 100% – claims for unused RNRB from more than one spouse or registered civil partner are possible but in total can't be more than 100% of the maximum available amount.

Under the RNRB provisions, direct descendants inherit a home that's left to them which becomes part of their estate. This could be under the provisions of the deceased's Will, under the rules of intestacy or by

some other legal means as a result of the person's death – for example, under a deed of variation.

#### **Main residence**

The RNRB applies to a property that's included in the deceased's estate and one in which they have lived. It needn't be their main residence, and no minimum occupation period applies.

If an individual has owned more than one home, their personal representatives can elect which one should qualify for RNRB.

The open market value of the property will be used less any liabilities secured against it, such as a mortgage. Where only a share of the home is left to direct descendants, the value and RNRB is apportioned.

#### **Complex area**

A home may already be held in Trust when an individual dies or it may be transferred into Trust upon their death. Whether the RNRB will be available in these circumstances will depend on the type of Trust, as this will determine whether the home is included in the deceased's estate, and also whether direct descendants are treated as inheriting the property.

This is a complex area, and HM Revenue & Customs provides only general guidance, with a recommendation that a solicitor or Trust specialist should be consulted to discuss whether the RNRB applies.

#### **Downsizing addition**

Estates that don't qualify for the full amount of RNRB may be entitled to an additional amount of RNRB – a downsizing addition if the following conditions apply: the deceased disposed of a former home and either downsized to a less valuable home or ceased to own a home on or after 8 July 2015; the former home would have qualified for the RNRB if it had been held until death; and at least some of the estate is inherited by direct descendants.

The downsizing addition will generally represent the amount of 'lost' RNRB that could have applied if the individual had died when they owned the more valuable property. However, it won't apply where the value of the replacement home they own when they die is worth more than the maximum available RNRB. It's also limited by the value of other assets left to direct descendants.

#### **Planning techniques**

The downsizing addition can also apply where an individual hasn't replaced a home they previously disposed of – provided they leave other assets to direct descendants on their death. The deceased's personal representatives must make a claim for the downsizing addition within two years of the end of the month in which the individual died.

Different planning options are available to address a potential IHT liability which can be incorporated into the financial arrangements where an estate is likely to exceed the threshold.

# LIFETIME TRANSFERS

## Removing the value of gifts from your estate.

Inheritance Tax exemptions can be achieved by means of making certain exempt transfers, which apply in a number of cases including wedding gifts, life assurance premiums, gifts to your family and charitable giving.

If appropriate, you can transfer some of your assets while you're alive – these are known as lifetime transfers. Whilst we are all free to do this whenever we want, it is important to be aware of the potential implications of such gifts with regard to Inheritance Tax. The two main types are 'potentially exempt transfers' and 'chargeable lifetime transfers'

### Exempt transfers

Potentially exempt transfers are lifetime gifts made directly to other individuals, which includes gifts to Bare Trusts. A similar lifetime gift made to most other types of Trust is a chargeable lifetime transfer. These rules apply to non-exempt transfers: gifts to a spouse are exempt, so are not subject to Inheritance Tax.

Where a potentially exempt transfer fails to satisfy the conditions to remain exempt – because the person who made the gift died within seven years – its value will form part of their estate. Survival for at least seven years, on the other hand, ensures full exemption from Inheritance Tax.

Chargeable lifetime transfers are not conditionally exempt from Inheritance Tax. If it is covered by the Nil-Rate Band (NRB) and the transferor survives at least seven

years, it will not attract a tax liability, but it could still impact on other chargeable transfers.

### Seven years

Chargeable lifetime transfers that exceed the available NRB when they are made result in a lifetime Inheritance Tax liability. Failure to survive for seven years results in the value of the chargeable lifetime transfers being included in the estate. If the chargeable lifetime transfers are subject to further Inheritance Tax on death, a credit is given for any lifetime Inheritance Tax paid.

Following a gift to an individual or a Bare Trust (a basic Trust in which the beneficiary has the absolute right to the capital and assets within the Trust, as well as the income generated from these assets), there are two potential outcomes: survival for seven years or more, and death before then. The former results in the potentially exempt transfer becoming fully exempt and no longer figuring in the Inheritance Tax assessment. In other case, the amount transferred less any Inheritance Tax exemptions is 'notionally' returned to the estate.

### Tax consequences

Anyone utilising potentially exempt transfers for tax migration purposes, therefore, should consider the consequences of failing to survive for seven years. Such an assessment will involve balancing the likelihood of surviving for seven years against the tax consequences of death within that period.

Failure to survive for the required seven-year period results in the full value of the potentially exempt transfers being notionally included within the estate; survival beyond then means nothing is included. It is taper relief which reduces the Inheritance Tax liability (not the value transferred) on the failed potentially exempt transfers after the full value has been returned to the estate.

### Earlier transfers

The value of the potentially exempt transfers is never tapered. The recipient of the failed potentially exempt transfers is liable for the Inheritance Tax due on the gift itself and benefits from any taper relief. The Inheritance Tax due on the potentially exempt transfers is deducted from the total Inheritance Tax bill, and the estate is liable for the balance.

Lifetime transfers are dealt with in chronological order upon death; earlier transfers are dealt with in priority to later ones, all of which are considered before the death estate. If a lifetime transfer is subject to Inheritance Tax because the NRB is not sufficient to cover it, the next step is to determine whether taper relief can reduce the tax bill for the recipient of the potentially exempt transfers.

### Sliding scale

The amount of Inheritance Tax payable is not static over the seven years prior to death. Rather, it is



reduced according to a sliding scale dependant on the passage of time from the giving of the gift to the individual's death.

No relief is available if death is within three years of the lifetime transfer. For survival for between three and seven years, taper relief at the following rates is available.

### Taper relief

The rate of Inheritance Tax gradually reduces over the seven-year period – this is called taper relief:

| *How long ago was the gift made? | **How much is the tax reduced? |
|----------------------------------|--------------------------------|
| *0-3 years                       | **No reduction                 |
| 3-4 years                        | 20%                            |
| 4-5 years                        | 40%                            |
| 5-6 years                        | 60%                            |
| 6-7 years                        | 80%                            |
| 7+ years                         | No tax to pay                  |

It's important to remember that taper relief only applies to the amount of tax the recipient pays on the value of the gift above the NRB. The rest of your estate will be charged with the full rate of Inheritance Tax – usually 40%.

### Donor pays

The tax treatment of chargeable lifetime transfers has some similarities to potentially exempt transfers but with a number of differences. When a chargeable lifetime transfer is made, it is assessed against the donor's NRB. If there is an excess above the NRB, it is taxed at 20% if the recipient

pays the tax, or 25% if the donor pays the tax.

The same seven-year rule that applies to potentially exempt transfers then applies. Failure to survive to the end of this period results in Inheritance Tax becoming due on the chargeable lifetime transfers, payable by the recipient. The tax rate is the usual 40% on amounts in excess of the NRB, but taper relief can reduce the tax bill, and credit is given for any lifetime tax paid.

### Gift of capital

The seven-year rules that apply to potentially exempt transfers and chargeable lifetime transfers could increase the Inheritance Tax bill for those who fail to survive for long enough after making a gift of capital.

If Inheritance Tax is due in respect of a failed potentially exempt transfer, it is payable by the recipient. If Inheritance Tax is due in respect of a chargeable lifetime transfer on death, it is payable by the trustees. Any remaining Inheritance Tax is payable by the estate.

### Appropriate Trust

The Inheritance Tax difference can be calculated and covered by a level or decreasing term assurance policy written in an appropriate Trust for the benefit of whoever will be affected by the Inheritance Tax liability and in order to keep the proceeds out of the settlor's Inheritance Tax estate. Which is more suitable, and the level of cover required will depend on the circumstances. If the potentially exempt transfers or chargeable lifetime transfers are within the NRB, taper relief will not apply.

However, this does not mean that no cover is required. Death within seven years will result in the full value of the transfer being included in the estate, with the knock-on effect that other estate assets up to the value of the potentially exempt transfers or chargeable

lifetime transfers could suffer tax that they would have avoided had the donor survived for seven years.

### Estate legatees

A seven-year level term policy could be the most appropriate type of policy in this situation. Any additional Inheritance Tax is payable by the estate, so a Trust for the benefit of the estate legatees will normally be required.

Where the potentially exempt transfers or chargeable lifetime transfers exceed the NRB, the tapered Inheritance Tax liability that will result from death after the potentially exempt transfers or chargeable lifetime transfers are made can be estimated.

### 'Gift inter vivos'

A special form of 'gift inter vivos' (a life assurance policy that provides a lump sum to cover the potential Inheritance Tax liability that could arise if the donor of a gift dies within seven years of making the gift) is put in place (written in an appropriate Trust) to cover the gradually declining tax liability that may fall on the recipient of the gift.

Trustees might want to use a life of another policy to cover a potential liability. Taper relief only applies to the tax: the full value of the gift is included within the estate, which in this situation will use up the NRB that becomes available to the rest of the estate after seven years.

### Whole of life cover

Therefore, the estate itself will also be liable to additional Inheritance Tax on death within seven years, and depending on the circumstances, a separate level term policy written in an appropriate trust for the estate legatees might also be required.

Where an Inheritance Tax liability continues after any potentially exempt transfers or chargeable lifetime transfers have dropped out of account, whole of life cover written in an appropriate Trust should also be considered.





# PROTECTING FAMILY WEALTH WITH TRUSTS

## Protecting family wealth for future generations.

Trusts are used to protect family wealth for future generations, reducing the inter-generational Flow of Inheritance Tax and ensuring bloodline protection for your estate from outside claims.

The way in which assets held within Trusts are treated for Inheritance Tax purposes depends on whether the choice of beneficiaries is fixed or discretionary.

The most popular types of Trust commonly used for Inheritance Tax planning can usually be written on either an 'absolute' or a 'discretionary' basis and the taxation treatment is very different for each.

A Trust is a fiduciary arrangement that allows a third-party, or trustee, to hold assets on behalf of a beneficiary or beneficiaries. Once the Trust has been created, a person can use it to 'ring-fence' assets.

### Trusts terms:

- Settlor – the person setting up the Trust.
- Trustees – the people tasked with looking after the Trust and paying out its assets.
- Beneficiaries – the people who benefit from the assets held in Trust.

# BARE TRUSTS

## Held for the benefit of a specified beneficiary.

Bare Trusts are also known as 'Absolute' or 'Fixed Interest Trusts', and there can be subtle differences. The settlor – the person creating the Trust – makes a gift into the Trust which is held for the benefit of a specified beneficiary. If the Trust is for more than one beneficiary, each person's share of the Trust fund must be specified. For lump sum investments, after allowing for any available annual exemptions, the balance of the gift is a potentially exempt transfer for Inheritance Tax purposes. As long as the settlor survives for seven years from the date of the gift, it falls outside their estate.

The Trust fund falls into the beneficiary's Inheritance Tax estate from the date of the initial gift. With Loan Trusts, there isn't any initial gift – the Trust is created with a loan instead. And with Discounted Gift plans, as long as the settlor is fully underwritten at the outset, the value of the initial gift is reduced by the value of the settlor's retained rights.

### Income exemption

When family protection policies are set up in Bare Trusts, regular premiums are usually exempt transfers for Inheritance Tax purposes. The normal expenditure out of income exemption often applies, as long as the cost of the premiums can be covered out of the settlor's excess income in the same tax year, without affecting their normal standard of living.

Where this isn't possible, the annual exemption often covers some or all

of the premiums. Any premiums that are non-exempt transfers into the Trust are potentially exempt transfers. Special valuation rules apply when existing life policies are assigned into family Trusts. The transfer of value for Inheritance Tax purposes is treated as the greater of the open market value and the value of the premiums paid up to the date the policy is transferred into Trust.

### Parental settlement

There's an adjustment to the premiums paid calculation for unit linked policies if the unit value has fallen since the premium was paid. The open market value is always used for term assurance policies that pay out only on death, even if the value of the premiums paid is greater.

With a Bare Trust, there are no ongoing Inheritance Tax reporting requirements and no further Inheritance Tax implications.

With protection policies, this applies whether or not the policy can acquire a surrender value. Where the Trust holds a lump sum investment, the tax on any income and gains usually falls on the beneficiaries. The most common exception is where a parent has made a gift into Trust for their minor child or stepchild, where parental settlement rules apply to the Income Tax treatment.

### Trust administration

Therefore, the Trust administration is relatively straightforward even for lump sum investments. Where relevant, the trustees simply need to

choose appropriate investments and review these regularly.

With a Bare Trust, the trustees look after the Trust property for the known beneficiaries, who become absolutely entitled to it at age 18 (age 16 in Scotland). Once a gift is made or a Protection Trust set up, the beneficiaries can't be changed. Money can't be withheld from them beyond the age of entitlement. This may make them inappropriate to many clients who'd prefer to retain a greater degree of control.

### Trust fund

With a Loan Trust, this means repaying any outstanding loan. With a Discounted Gift Trust, it means securing the settlor's right to receive their fixed payments for the rest of their life. With protection policies in Bare Trusts, any policy proceeds that haven't been carved out for the life assured's benefit under a Split Trust must be paid to the Trust beneficiary if they're an adult. Where the beneficiary is a minor, the trustees must use the Trust fund for their benefit.

Difficulties can arise if it's discovered that a Trust beneficiary has predeceased the life assured. In this case, the proceeds belong to the legatees of the deceased beneficiary's estate, which can leave the trustees with the task of tracing them. The fact that beneficiaries are absolutely entitled to the funds also means the Trust offers no protection of the funds from third parties, for example, in the event of a beneficiary's divorce or bankruptcy.

# DISCRETIONARY TRUST

## Wide class of potential beneficiaries.

With a Discretionary Trust, the settlor makes a gift into Trust, and the trustees hold the Trust fund for a wide class of potential beneficiaries. This is known as 'settled' or 'relevant' property. For lump sum investments, the initial gift is a chargeable lifetime transfer for Inheritance Tax purposes.

It's possible to use any available annual exemptions. If the total non-exempt amount gifted is greater than the settlor's available nil-rate band, there's an immediate Inheritance Tax charge at the 20% lifetime rate – or effectively 25% if the settlor pays the tax.

### Other planning

The settlor's available Nil-Rate Band (NRB) is essentially the current NRB less any chargeable lifetime transfers they've made in the previous seven years. So, in many cases where no other planning is in place, this will simply be the current NRB, which is currently £325,000. The Residence Nil-Rate Band (RNRB) isn't available to Trusts or any lifetime gifting.

Again, there's no initial gift when setting up a Loan Trust, and the initial gift is usually discounted when setting up a Discounted Gift plan. Where a cash gift exceeds the available NRB, or an asset is gifted which exceeds 80% of the NRB, the gift must be reported to HM Revenue & Customs (HMRC) on an IHT 100.

### Family protection

When family protection policies are

set up in Discretionary Trusts, regular premiums are usually exempt transfers for Inheritance Tax purposes. Any premiums that are non-exempt transfers into the Trust will be chargeable lifetime transfers. Special valuation rules for existing policies assigned into Trust apply.

As well as the potential for an immediate Inheritance Tax charge on the creation of the Trust, there are two other points at which Inheritance Tax charges will apply. These are known as 'periodic charges' and 'exit charges'. Periodic charges apply at every ten-yearly anniversary of the creation of the Trust.

### Investment bond

Exit charges may apply when funds leave the Trust. The calculations can be complex but are a maximum of 6% of the value of the Trust fund. In many cases, they'll be considerably less than this – in simple terms, the 6% is applied on the value in excess of the Trust's available NRB.

However, even where there is little or, in some circumstances, no tax to pay, the trustees still need to submit an IHT 100 to HMRC. Under current legislation, HMRC will do any calculations required on request. For a Gift Trust holding an investment bond, the value of the Trust fund will be the open market value of the policy – normally its surrender value.

### Retained rights

For a Loan Trust, the value of the trust fund is the bond value less the

amount of any outstanding loan still repayable on demand to the settlor. Retained rights can be recalculated as if the settlor was ten years older.

For Discounted Gift schemes, the value of the Trust fund normally excludes the value of the settlor's retained rights – and in most cases, HMRC are willing to accept pragmatic valuations. For example, where the settlor was fully underwritten at the outset, and is not terminally ill at a ten-yearly anniversary, any initial discount taking account of the value of the settlor's retained rights can be recalculated as if the settlor was ten years older than at the outset.

### Open market

If a protection policy with no surrender value is held in a Discretionary Trust, there will usually be no periodic charges at each ten-yearly anniversary. However, a charge could apply if a claim has been paid out and the funds are still in the Trust.

In addition, if a life assured is in severe ill health around a ten-yearly anniversary, the policy could have an open market value close to the claim value. If so, this should be taken into account when calculating any periodic charge.

### Chargeable event

Where discretionary Trusts hold investments, the tax on income and gains can also be complex, particularly where income-producing assets are used.

Where appropriate, some of these complications could be avoided by an individual investing in life assurance investment bonds, as these are non-income-producing assets and allow trustees to control the tax points on any chargeable event gains.

Bare Trusts give the trustees discretion over who benefits and when. The Trust deed will set out all the potential beneficiaries, and these usually include a wide range of family members, plus any other individuals the settlor has chosen. This gives the trustees a high degree of control over the funds. The settlor is often also a trustee to help ensure their wishes are considered during their lifetime.

#### **Trust Provisions**

In addition, the settlor can provide the trustees with a letter of wishes identifying who they'd like to benefit and when. The letter isn't legally binding but can give the trustees clear guidance, which can be amended if circumstances change. The settlor might also be able to appoint a protector, whose powers depend on the Trust provisions, but usually include some degree of veto.

Family disputes are not uncommon. Some prefer to pass funds down when the beneficiaries are slightly older than age 18. A Discretionary Trust also provides greater protection from third parties, for example, in the event of a potential beneficiary's divorce or bankruptcy, although in recent years this has come under greater challenge.



**A DISCRETIONARY  
TRUST CAN PROVIDE  
GREATER PROTECTION  
FROM THIRD PARTIES.**

# FLEXIBLE TRUSTS WITH DEFAULT BENEFICIARIES

**Discretion over which of the default and potential beneficiaries actually benefit.**

Flexible Trusts are similar to a fully Discretionary Trust, except that alongside a wide class of potential beneficiaries, there must be at least one named default beneficiary.

Flexible Trusts with default beneficiaries set up in the settlor's lifetime from 22 March 2006 onwards are treated in exactly the same way as Discretionary Trusts for Inheritance Tax purposes.

Different Inheritance Tax rules apply to older Trusts set up by 21 March 2006 that meet specified criteria and some Will Trusts.

All post-21 March 2006 lifetime Trusts of this type are taxed in the same way as fully Discretionary Trusts for Inheritance Tax and Capital Gains Tax purposes.

## **Default beneficiary**

For Income Tax purposes, any income is payable to and taxable on the default beneficiary. However, this doesn't apply to even regular withdrawals from investment bonds, which are non-income-producing assets.

Bond withdrawals are capital payments, even though chargeable event gains are subject to Income Tax.

As with Bare Trusts, the parental settlement rules apply if parents make gifts into Trust for their minor children or stepchildren.

## **Significant differences**

When it comes to beneficiaries and control, there are no significant differences between fully

Discretionary Trusts and this type of Trust. There will be a wide range of potential beneficiaries.

In addition, there will be one or more named default beneficiaries.

Naming a default beneficiary is no more binding on the trustees than providing a letter of wishes setting out whom the settlor would like to benefit from the Trust fund.

The trustees still have discretion over which of the default and potential beneficiaries actually benefit and when.

Some older Flexible Trusts limit the trustees' discretionary powers to within two years of the settlor's death, but this is no longer a common feature of this type of Trust.



# SPLIT TRUSTS

## Family protection policies.

Split Trusts are often used for family protection policies with critical illness or terminal illness benefits in addition to life cover.

Split Trusts can be Bare Trusts, Discretionary Trusts, or Flexible Trusts with default beneficiaries.

When using this type of Trust, the settlor/life assured carves out the right to receive any critical illness or terminal illness benefit from the outset, so there aren't any gift with reservation issues.

In the event of a claim, the provider normally pays any policy benefits to the trustees, who then pay any carved-out entitlements to the life assured and use any other proceeds to benefit the Trust beneficiaries.

### Trade-off

If terminal illness benefit is carved out, this could result in the payment ending up back in the life assured's Inheritance Tax estate before their death. It is treated as falling into their Inheritance Tax estate once they meet the conditions for payment.

Essentially, these types of Trust offer a trade-off between simplicity and the degree of control available to the settlor and their chosen trustees. For most, control is the more significant aspect, especially where any lump sum gifts can stay within a settlor's available Inheritance Tax NRB.

### Maximum control

Keeping gifts within the NRB and using non-income-producing

assets such as investment bonds can allow a settlor to create a Trust with maximum control, no initial Inheritance Tax charge and limited ongoing administrative or tax burdens.

In other cases, for example, grandparents funding for school fees, the Bare Trust may offer advantages. This is because tax will fall on the grandchildren, and most of the funds may be used up by the age of 18. The considerations may be different when considering family protection policies, where the settlor will often be dead when policy proceeds are paid out.

### Policy proceeds

A Bare Trust ensures the policy proceeds will be payable to one or more individuals, with no uncertainty about whether the trustees will follow the deceased's wishes. However, this can also mean that the only solution to a change in circumstances, such as divorce, is to start again with a new policy.

Settlors are often excluded from benefiting under Discretionary and Flexible Trusts. Where this applies, this type of Trust isn't suitable for use with joint life, first death protection policies if the primary



# PROTECTING ASSETS FOR THE NEXT GENERATION

## Six tips for wealth preservation and transfer planning.

With careful planning and professional financial advice, it is possible to take preventative action to either reduce or mitigate a person's beneficiaries' Inheritance Tax bill – or mitigate it altogether. These are some of the main areas to consider.

### 1. Make a Will

A vital element of effective estate preservation is to make a Will. Making a Will ensures an individual's assets are distributed in accordance with their wishes. This is particularly important if the person has a spouse or registered civil partner.

Even though there is no Inheritance Tax payable between both parties, there could be tax payable if one person dies intestate without a Will. Without a Will in place, an estate falls under the laws of intestacy – and this means the estate may not be divided up in the way the deceased person wanted it to be.

### 2. Make allowable gifts

A person can give cash or gifts worth up to £3,000 in total each tax year, and these will be exempt from Inheritance Tax when they die.

They can carry forward any unused part of the £3,000 exemption to the following year, but they must use it, or it will be lost.

Parents can give cash or gifts worth up to £5,000 when a child gets married, grandparents up to £2,500, and anyone else up to £1,000. Small gifts of up to £250 a year can also be made to as many people as an individual likes.

### 3. Give away assets

Parents are increasingly providing children with funds to help them buy their own home. This can be done through a gift, and provided the parents survive for seven years after making it, the money automatically moves outside of their estate for Inheritance Tax calculations, irrespective of size.

### 4. Make use of Trusts

Assets can be put in an appropriate Trust, thereby no longer forming part of the estate.

There are many types of Trust available and they can be set up simply at little or no charge. They usually involve parents (settlers) investing a sum of money into a Trust. The Trust has to be set up with trustees – a suggested minimum of two – whose role is to ensure that on the death of the settlers, the investment is paid out according to the settlers' wishes. In most cases, this will be to children or grandchildren.

The most widely used Trust is a Discretionary Trust, which can be set up in a way that the settlers (parents) still have access to income or parts of the capital.

It can seem daunting to put money away in a Trust, but they can be unwound in the event of a family crisis and monies returned to the settlers via the beneficiaries.

### 5. The income over expenditure rule

As well as considering putting lump sums into an appropriate Trust,

people can also make monthly contributions into certain savings or insurance policies and put them into an appropriate Trust.

The monthly contributions are potentially subject to Inheritance Tax, but if the person can prove that these payments are not compromising their standard of living, they are exempt.

### 6. Provide for the tax

If a person is not in a position to take avoiding action, an alternative approach is to make provision for paying Inheritance Tax when it is due.

The tax has to be paid within six months of death (interest is added after this time). Because probate must be granted before any money can be released from an estate, the executor may have to borrow money or use their own funds to pay the Inheritance Tax bill.

This is where life assurance policies written in an appropriate Trust come into their own.

A life assurance policy is taken out on both a husband's and wife's life with the proceeds payable only on second death. The amount of cover should be equal to the expected Inheritance Tax liability. By putting the policy in an appropriate Trust, it means it does not form part of the estate.

The proceeds can then be used to pay any Inheritance Tax bill straight away without the need for the executors to borrow.





## **CONCLUSION**

If you do not plan for what happens to your assets when you die, more of your estate than necessary could be exposed to Inheritance Tax. You may also want to be sure that the right people will get the right amounts at the right time.

From essential estate planning, such as the establishment of Wills and Power of Attorney, to options such as making the most of exemptions, giving away excess income and creating Trusts, there are numerous estate planning possibilities.

Everyone has different requirements and motivations – the right solutions for you are the ones that suit your personal circumstances. We can work with you to discover what these are. Our estate planning advice service is designed to help you maximise your wealth and minimise a potential Inheritance Tax bill.

Whether building a financial plan with you from the start or reviewing your existing arrangements, we can help guide you through the process to defining your goals and recommend a tailored strategy to meet your individual needs that will be flexible enough to adapt as your life changes.

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