

CLIENT MEMORANDUM

DOES YOUR WILL STILL WORK?

Quite unexpectedly, the Chancellor announced in the 2006 Budget significant changes in the inheritance tax legislation as it applies to gifts by will. Initially it was feared that as a result a substantial number of wills would need review and quite possibly rewriting but the proposals have since been tempered with a number of relaxations which have dealt with the main concerns expressed by the professional Institutes. The underlying policy appears to be that the use of trusts both in lifetime and on death is to be discouraged by tax provisions which encourage outright gifts to other individuals. Furthermore, Government policy is that gifts to infant children should not be tied up in trust beyond their eighteenth birthday and, if they are, some inheritance tax will be payable.

Inheritance tax on death

Inheritance tax ('IHT') on personally held assets has a relatively simple charging structure. There is a nil rate band which has been increased for the 2006/2007 tax year to £285,000. Next year it is set to increase to £300,000. Once a person's estate exceeds the nil rate band, IHT on death is payable at 40 per cent on the excess. Any gifts to individuals made in the seven years prior to the donor's death, less the annual exemption £3,000 if available and if not covered by another exemption, become chargeable to tax. However, if the gift was made more than three years before the donor's death, the tax (if any) on the gift is reduced by a tapering provision. Note that the reduction is not in the amount of the gift, but only on the tax payable in respect of it. Lifetime gifts which become chargeable on death are primarily allocated to the nil rate band, pushing the estate on death into the chargeable band at which 40 per cent tax is payable. The result of this position is that a lifetime gift of £285,000 in cash which is made six-and-a-half years prior to death achieves no tax saving at all because

the gift absorbs the whole of the nil rate band, leaving the balance of the testator's estate to pay tax at 40 per cent.

Capital gains tax on death

No capital gains tax is payable on personally held assets at the time of death. Instead all accrued gains are wiped out and the base cost of the asset is re-set to their open market value at the time of death. This rule continues to apply following the 2006 Budget.

The rule also applies to assets held in trust for a person for his or her lifetime, where the trust in that person's favour was made before 22 March 2006 or where there had been substituted a new interest in possession trust before 6 April 2008. The rule will not, however, apply to new lifetime trusts created after Budget day this year. Instead assets in these new trusts will benefit from capital gains tax 'hold over relief'; this means that the assets can, by election made jointly by the trustees and the beneficiary, pass out of the trust at their capital gains tax base costs, rather than the market value at the time the trust is wound up.

Existing wills

In recent years most people have preferred to keep the provisions of their will relatively simple, and, wherever possible, to avoid the use of trusts. A simple will provides for all assets to pass to the spouse or civil partner, if he or she survives, and if not assets then pass direct to children, or into trust for them if they are minors to be paid to them after they have attained the age of eighteen.

This simple type of will has often been embellished, on receipt of professional advice, by the use of what is known as a 'nil rate band trust'. This is a method of dealing with the problem by which the nil rate band of the first to die of husband and wife becomes wasted if all the assets pass to the surviving spouse, because there is an outright exemption for gifts in such circumstances. It has therefore been common to provide for a legacy of an amount equal to the testator's available nil rate band in favour of a discretionary trust for all members of the family, including the surviving spouse. This avoids the assets in the nil rate band trust passing into the estate of the surviving spouse, so that they will not be aggregated with that spouse's free estate on his or her later death. These trusts have been successfully employed for many years, although more recently the Revenue has attempted to introduce detailed requirements for the administration of the trust. The Revenue has also taken the view that a share in the family home could not benefit from the IHT advantages of a nil rate band trust for technical reasons, which have been widely disputed, but as a result it was accepted that the viable alternative was to place a charge on the home in favour of the trustees of the nil rate band trust, the amount of the charge being equal to the available nil rate band. Thus the trust would have as its only asset an amount payable to it under the charge whenever the property came to be sold.

More complex wills

This simple type of will has suited many ordinary situations and it will continue to be tax efficient following the 2006 Budget. In particular, nil rate band trusts will not need to be revisited after the Budget and in fact it may now be possible for them to receive a share in the family home without losing their tax advantages.

However, more complex wills have often been required particularly where one or more of the parties to a marriage has previously been divorced so that there are children of a previous marriage to be considered. In such a case it might be appropriate to set up a trust of the testator's estate on death so that the income, or the use of the testator's share in the family home, can be enjoyed by the surviving spouse for life, and thereafter the estate may be payable to the children of the previous marriage.

Will trusts have also been appropriate where the testator wishes to provide for another member of the family, or a close acquaintance, for his or her life, and thereafter the assets may be distributable to different beneficiaries. Also those enjoying substantial wealth through landed estates have commonly felt it appropriate to tie up the assets in trust following their death in order to protect the estate from the claims of creditors, or to prevent it being dissipated by falling into the hands of a beneficiary not capable of managing it effectively.

In the past, only discretionary trusts have incurred periodic charges to inheritance tax. These are calculated according to a complex formula which gives a maximum tax rate of 6 per cent, and the charge arises every ten years with a proportionate charge being applied if capital funds are paid out between 10-yearly charge dates. As noted below, these periodic charges will now be applied to certain other types of trust.

After the 2006 Budget

Will trusts may still be tax efficient following the 2006 Budget, but Government policy is to prevent assets being held in trust over different generations. Trusts which will not bear periodic inheritance tax charges are:

1. Trusts in favour of another individual to receive the income for life. If the trust is in favour of the surviving spouse, the spouse exemption will apply. The funds in the trust will form part of the life tenant's inheritance tax estate, just as they did prior to the 2006 Budget.
2. Trusts for bereaved minors: a will trust in favour of the testator's own infant children who must receive their inheritance on attaining the age of eighteen will be free of inheritance tax charges once it is set up and running, although it does not benefit from any exemption from inheritance tax as regards inheritance on the testator's estate. The trust may alternatively delay entitlement to the funds until the child is aged 25 but in that event periodic inheritance tax charges apply after the child's 18th birthday.

These rules will apply equally if the bereaved minor's trust does not commence until the expiry of an initial trust in favour of another individual, such as the surviving spouse.

Reviewing existing wills

It is important to note that the date on which a particular will was executed is of no consequence whatsoever. The will speaks from the date of death, and accordingly some wills which have been made for tax efficiency in the past may now need to be redrawn to conform with the new rules where the testator is still alive. In these circumstances, the position may be assisted by a post-death deed of variation of the will, although there are limits on what can be achieved with such deeds; in particular, the potential interests of infant children under a will cannot be varied unless it is clear that the variation can only operate in their favour.

New wills

Testators now face difficult choices if they wish to provide for any form of trusts in their wills.

As regards trusts for infant children of their own, these can either provide that the funds must be distributed absolutely to the children as and when they attain the age of eighteen, in which case no inheritance tax ten yearly charges will apply to the trust.

Alternatively it may be felt that this age is too young for children to receive their inheritance outright, and it would be better to delay it until the age of 25; this type of trust will be free of inheritance tax whilst the beneficiaries are under the age of 18 but will incur the periodic inheritance tax charge on the value of the trust funds in excess of the nil rate after they attain the age of 18. If the trust funds are likely to be within the nil rate band, it will not matter which type of children's trust is used.

An interest in possession or life interest trust set up by a will for an adult beneficiary will continue to enjoy the inheritance tax régime which has applied hitherto. As a result, the assets forming the trust fund will be part of the beneficiary's inheritance tax estate. If the funds remain in trust until the death of the life tenant, there will be a chargeable transfer for inheritance tax purposes at that stage and the trust funds will be aggregated with the funds in the beneficiary's own free estate in order to determine how much inheritance tax is payable on the total. If the combined assets exceed the inheritance tax nil rate band at that time, tax at 40 per cent (assuming no change in the rate of inheritance tax) will be payable on that excess, and will be apportioned between the free estate and the trust funds according to the values of each.

If the life interest is terminated before the beneficiary dies, there will be a potentially exempt transfer if the funds pass out of the trust absolutely to another individual. There is also a potentially exempt transfer when the interest in possession terminates in lifetime and the trust fund is therefore held on continuing trusts for the infant children of the testator until they become eighteen.

There are now no special provisions for grandparents who provide for their grandchildren under the age of 18 in their wills. In other words, the value put into the trust on the death of the grandparent will bear inheritance tax in the normal way, and inheritance tax periodic charges will also be applied to the trust fund. Strangely, however, if the grandchildren are over the age of 18, funds can be placed on interest

in possession trusts for them and no inheritance tax periodic charges will apply. Instead the position will be as set out above in relation to life interests set up under a will.

Generally

The Budget changes will clearly have a major impact on the drafting of wills, and unfortunately this will mean many people will need to reconsider the terms of their existing wills.

FOR GENERAL INFORMATION ONLY

Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic.

Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.