

REDUCING INHERITANCE TAX – Nil Rate Band Discretionary Trusts

Inheritance Tax Basics

Any inheritance passing from spouse to spouse (or one partner in a civil partnership to the other), is usually entirely exempt from Inheritance Tax (“IHT”).

However, when assets pass on to the next generation, IHT is paid on their value. The first £300,000 (in tax year 2007/08) is taxed at zero percent, and is usually called the “Nil Rate Band”. The rest is taxed at 40%.

So an estate of £500,000 pays tax of 40% on £200,000 – IHT of £80,000

If a husband worth £500,000 dies and passes his entire estate to his wife, also worth £500,000 at the time, and then she dies, you might be forgiven for thinking the tax on the combined £1m would be double, i.e. £160,000. You would be wrong.

The reason is that the Nil Rate Band of the husband is lost. Only one Nil Rate Band applies, namely on the wife’s subsequent death. So IHT at 40% on £700,000 (£1m less £300,000) is payable, namely £280,000; £120,000 more than you might have thought.

How spouses, or civil partners’, wills can mitigate their IHT

In essence, each must take advantage of the Nil Rate Band. This is achieved by giving a legacy to the next generation, or other beneficiaries, equivalent to the Nil Rate Band at the time of the death of the first. There are, however, problems. A widow might be left with inadequate resources because of changed circumstances. We at Munday’s therefore prefer to design the gift in the will in such a way that it will be possible for the survivor to benefit from the Nil Rate Band legacy, using discretionary trusts.

The survivor of the two is named as one of the beneficiaries of the Nil Rate Band legacy, jointly with the children, grandchildren or others; any of them can potentially inherit. The trustees of the legacy may well defer making a decision how to divide the legacy up. So long as the widow or surviving partner is alive, they can decide from year to year how to use the assets (or the income they deliver) for the benefit of the wider family. The widow/widower or surviving partner is usually one of the trustees, which protects his or her position; the trustees’ decisions must be made unanimously.

It can make sense that the Discretionary Trust of the Nil Rate Band should continue, sitting alongside the estate of the survivor as a fund into which the survivor can (with the agreement of the other trustees) dip from time to time. Despite this availability to the survivor, the fund will not be treated as part of his or her estate on death. The whole fund, and all growth in its value, will be excluded from tax.

Joining the family home in

In many cases, it is difficult to identify savings or other assets, which can be used to satisfy the legacy on the first death (both spouses or partners would need individual assets of this type exceeding £300,000). Therefore, to gain the full tax benefit, maybe their respective shares in the family home could be allocated to the legacy?

This can be troublesome. It may lead the Revenue to claim that the survivor continues to occupy the home partly by dint of the trusts of the Nil Rate Band Legacy; they may then claim tax on the full fund. There are various strategies that can be adopted to avoid these problems, one being the use of a loan mechanism. Basically, the executors agree to lend enough money from the residuary estate, to the trustees of the Nil Rate Band Legacy, to satisfy it in full; but the Nil Rate Band Trustees do not call the debt in. It is left outstanding, and on the surviving spouse's (or partner's) later death, it is a debt which reduces his or her taxable estate. It is usually charged on the other assets passing to them.

But there are further potential difficulties. The debt may not be deductible from the value of the survivor's assets on the second death, in calculating the tax. The Revenue may be able to show that the survivor's debt relates to funds which he or she originally gave (possibly decades before) to the one who died first. For example, if the only breadwinner was the man, his purchase of the family home in joint names meant that he had contributed all the funds for his wife's half ownership – that seems harmless enough, doesn't it? The problem is that if the man dies second, and beforehand he accepts the liability to the trustees, he has effectively taken on a liability for money which was his originally. The debt will not be deductible (see below about S103 Finance Act 1986).

Planning point

We need to ask Clients about who contributed to each house they have occupied over the years. Armed with that information, we can decide on the structure that will avoid these problems.

A technical note for the benefit of the technically minded, following widespread Press coverage

The case of *Phizackerley v CIR* may have worried people unnecessarily.

Most members of the public will not be aware of the operation of s103 Finance Act 1986. The mischief s103 was designed to prevent is the situation where a person tries in effect to reserve a benefit out of a lifetime gift. It can be seen in the following example.

A gives freehold land Blackacre to B and, then or later, B lends £10,000 to A. If at A's death the £10,000 loan is still outstanding it is not deductible in calculating the value of his estate to the extent that Blackacre exceeds £10,000 in value. As will be seen, the effect of this is to prevent A from deriving a £10,000 "cash back" benefit to himself by reference to the gift of Blackacre.

The facts in the *Phizackerley* case

Dr Phizackerley, a consultant biochemist, had lived in tied accommodation until his retirement in 1992 when he and his wife purchased, for £150,000, a small house which was put in their names as joint tenants. The agreed Statement of Facts, part of the evidence on which the case was decided, was that "Mrs Phizackerley did not work during her marriage, and the funds must have been provided by the Deceased."

In 1996 Dr Phizackerley severed the joint tenancy so that he and Mrs Phizackerley held the property that they had purchased as tenants in common. The same week Mrs Phizackerley made a will which left the nil-rate sum on discretionary trusts and gave the residue of the estate to her husband (and this was crucial) absolutely. She died in 2000. Pursuant to the terms of the will, Mrs Phizackerley's half share in the house was transferred, after her death, to Dr Phizackerley, who promised to pay the trustees of the nil-rate sum £150,000 (index-linked). On Dr Phizackerley's death two years later his estate, ignoring the promise of payment to the trustees, was valued at just under £530,000.

The case was referred to the Special Commissioner to decide whether the liability, which had meanwhile increased to £153,222.99, was deductible from the estate of Dr Phizackerley or whether that deduction was prevented by s103 FA1986.

The arguments and the Decision

Section 103 FA 1986 prevents the deduction of the debt where, and to the extent that, the consideration given for the debt consists of "property derived from the Deceased". The Special Commissioner said that on the face of it, the half share in the house was indeed derived from the Deceased. It was the subject-matter of a disposition made by the Deceased, so the debt incurred by the Deceased in favour of the trustees of the nil-rate band was not deductible. So the tax planning failed.

Counsel for the taxpayer argued that s103(4) should apply, which would save the situation by "switching off" the provisions of s103(1) because in certain circumstances the initial disposition, the gift, may be left out of account as "maintenance of the family".

That argument was rejected by Rupert Baldry, Counsel for the Revenue.

Despite the taxpayer's "persuasive argument" the Special Commissioner rejected the maintenance argument and dismissed the appeal.

Commentary

It is our standard practice when taking instructions for debt or charge scheme wills, to make enquiries as to past gifts, and to advise on s103. Sometimes we suggest that the will of the first spouse to die leaves the residue of the estate on trust for the surviving spouse for life only, rather than absolutely. However, that is often not what is desired by clients in practice.

It is here that the agreed Statement of Facts in *Phizackerley* is particularly important. Setting aside the issue of whether it is, nowadays, proper to say that any wife "did not work during her marriage", as if to deny the value of the contribution that a wife makes who does not specifically earn money, it is probably increasingly common that, at some time during a marriage, particularly in the early years, both husband and wife will work. Most wives will be able to claim, as a matter of simple mathematics and without even having to take account of the attitude of the courts on divorce, that they have actually made a contribution to the cost of the house and that the purchase of the house in joint names does not lead to the automatic conclusion that "the funds must have been provided by the Deceased". Many families will be able to show that both husband and wife worked at various times during the marriage; that they both directly or indirectly contributed to the cost of one home after another; and that the family home that is in their joint ownership at the time of the death of the first of them to die is truly owned by them equally and that, for them, the facts of *Phizackerley* can be distinguished.

There is another more serious issue to address. S103 contains no time limit. The debt which the executors seek to deduct from the estate of the second spouse to die is, see s103(1) "subject to abatement to an extent proportionate to the value of any of the consideration for the debt or encumbrance which consisted of – (a) property derived from the Deceased; or (b) consideration (not being property derived from the Deceased) given by any person who was at any time entitled to, or amongst whose resources there was at any time included, any property derived from the Deceased." It does not matter how long ago the property passed from one spouse to the other, it could still be caught. Clearly, these are matters of proof. Some executors will take a more cavalier approach to their duties in delivering tax returns than they should. If there is any clear link between the debt which is to be deducted from the estate of the surviving spouse and a gift made, however long ago, by that spouse to the first spouse to die, it would seem that *Phizackerley* can apply. This case increases the burden on executors and their advisers, and the risk of the penalty for failure to make proper enquiries.

Practical implications

Where both spouses have helped to pay for the house, it may not be necessary to change anything. Where, however, there has ever been a substantial gift, existing structures will need to be reviewed. The problem arises only where the donor spouse is the second to die: so in the common case of value transferred in lifetime by husband to wife, where she survives him, there is no problem.

For more information or advice

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