

# Wills after Finance Act 2006

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## The hype

The Government lost face in the arguments over the Budget. Their assertion that only a very small minority of people would be affected by their original proposals was completely wrong. The impact of the proposals on the family unit, even on the first death of a married couple (or civil partnership), was clearly going to be severe; and it turned out that it was unintended. The professional bodies won a fine victory in getting the worst of the proposals dropped or ameliorated.

Where has it all taken us? Back a couple of generations in some ways. And into even more complex waters - tax losses (sometimes for the Treasury, sometimes for the unwitting family) will escalate like water losses from a city's pipes.

## Review your Will if....

Review your Will against the following checklist, to see if it needs amendment ('IHT' means inheritance tax, and 'CGT' means capital gains tax):

### NIL RATE BAND LEGACIES

- If your Will creates discretionary trusts of the Nil Rate Band ('NRB') on the death of the first of a married or civil partnered couple:
  - The IHT treatment remains beneficial, saving IHT on the second death at 40% of the value of the NRB at that time (saving currently £114,000).
    - **No change there, then.**
  - If you have also bought investment products using business property relief ('BPR') or agricultural property relief ('APR'), available through financial advisers, your Will *should be changed* to add them to the NRB discretionary trust fund.
- Then after the death of the first one, the survivor can buy those assets from the trustees and get a second bite at BPR or APR.

### ABSOLUTE GIFTS

- Where your Will gives a person (such as your spouse or adult children) an absolute, unencumbered right to assets on your death:
  - Unless the beneficiary is your spouse or civil partner, *IHT will be chargeable* on your death as before, at a marginal rate of 40%. Generally there will be a *beneficial CGT uplift* in base cost of the assets.
- **No change there, then.**

### LIFE INTEREST (INTEREST IN POSSESSION) TRUSTS

- Where your Will gives a person (usually called the 'life tenant') an immediate right just to income (not capital), *IHT will be chargeable* on your death as before (unless the life tenant is your spouse or civil partner), at a marginal rate of 40%. Generally there will be a *beneficial CGT uplift* in base cost of the assets.
  - **No change there, then.**

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- But then we have to look at the situation when the life tenant dies:
  - On the life tenant's later death, *IHT will again be chargeable* at a marginal rate of 40%, unless the assets then pass to charity. Generally there will be another *beneficial CGT uplift* in base cost of the assets.
    - **No change there, then.**
  - If the life tenant gives up his or her interest, and further trusts arise (unless particular types of minority or disabled trusts) this will now incur *immediate IHT* at 20%, although usually *no CGT* will arise at that point.
    - **That's a new IHT charge.**
  - If the life tenant gives up his or her interest and the assets pass outright to an individual or individuals, this will be a lifetime gift by the life tenant, *free of IHT unless the life tenant should die within 7 years*. In other words it will be a potentially exempt transfer or 'PET'. In this case, *CGT will arise* at that point.
    - **No change there, then.**
  - Furthermore, many wills made before the Budget gave trustees the right to stop the life tenant receiving the income, but allowed that same person to benefit in other ways. Such wills were highly effective for substantial reduction of IHT within families. They are *no longer effective*.
    - **That's effectively a new IHT charge.**
  - If the income right is set to end automatically e.g. on remarriage or cohabitation, and further trusts arise (unless particular types of minority or disabled trusts) this will now incur *immediate IHT* at 20%, although *no CGT* will arise at that point.
    - **That's a new IHT charge.**
  - If the income right is set to end automatically e.g. on remarriage or cohabitation, and the assets pass outright to an individual or individuals, this will be a lifetime gift by the life tenant, *free of IHT unless the life tenant should die within 7 years*. In other words it will be a PET. In this case, *CGT will arise* at that point.
    - **No change there, then.**
- If your Will gives life tenant No.1 an immediate right just to income (not capital) on your death, and then goes on to give a second income only interest, to life tenant No.2 on the death of life tenant No.1:
  - *IHT will be chargeable* on life tenant No.1's death as before, at a marginal rate of 40% (unless life tenant No.2 is the spouse or civil partner of life tenant No.1); but there will be *no CGT* and generally there will be a *beneficial CGT uplift* in base cost of the assets.
  - If life tenant No.1 dies, or releases his or her life interest, **before** 5<sup>th</sup> April 2008, then on life tenant No.2's subsequent death *IHT will be chargeable again*, at the same marginal rate of 40%; but again there will be *no CGT* and generally there will be a *beneficial CGT uplift* in base cost of the assets.
    - **No change there, then.**

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- However, if life tenant No.1 dies, or releases his or her life interest, **after 5<sup>th</sup> April 2008, IHT will become payable every 10 years** thereafter but there will be *no IHT to pay* merely because of the eventual death of life tenant No.2. That death will have *no CGT effect either*. As from life tenant No.1's death, it will be possible (if the will is drafted appropriately) to pass assets to beneficiaries with *gains held over*, but with a *proportionate IHT charge based on the 6% rate*.
  - **That's a lost 40% IHT charge, replaced by a new decennial IHT charge at the 6% rate and potentially a loss of one CGT benefit in return for getting another.**
  - This will hurt particularly in the case of a trust of a house occupied by life tenant No.1 and then subsequently by life tenant No.2, where there is no rent to help fund the tax.
  - The subsequent beneficiaries (e.g. your child's own future children) will be unable to use their interest under the trust for IHT planning in the way they could previously, because it will no longer be an exempt asset.
  - **That's effectively a new IHT charge.**
  - However, the mere fact of life tenant No.2's death will not (as it used to) cause a charge to IHT. Depending on his or her life expectancy, the IHT charge overall may be less than under the old rules.
  - **That might actually mean a lower IHT charge.**
- If your Will gives someone an income right starting some time after the date of your death, other than following a previous life interest (e.g. your will gives your trustees discretions over income and capital whilst your child is under 25, and then an income only interest to the child at 25):
  - *Additional IHT will be payable every 10 years at the 6% rate*, from your death right through the life tenant's lifetime. It will be possible (if the will is drafted appropriately) to pass assets to the life tenant or other beneficiaries with *gains held over*, but with a *proportionate IHT charge based on the 6% rate*.
    - **That's a new IHT charge, especially disadvantageous where the life tenant is young, but potentially a new CGT benefit.**
  - The subsequent beneficiaries (e.g. your child's own future children) will be unable to use their interest under the trust for IHT planning in the way they could previously, because it will no longer be an exempt asset.
    - **That's effectively a new IHT charge.**

## CHILDREN'S TRUSTS

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### Trusts for *your own* children absolutely, or at 18

- If your Will leaves assets to *your own children*:
  - So that they will become absolutely entitled at 18 to:
    - The assets
    - Their entire income and
    - All accumulations of such income
  - And all income and capital used whilst they are under 18 either cannot be applied for anyone else, or are in practice only used for them

There will be *no additional IHT* charge

- **No change there, then. But an unpopular form, because children are too young at 18 to receive significant inheritances.**

Note that trustees can have no flexibility as to how to share out the income and capital between your children.

### Trusts for *your own* children, only when they achieve an age between 18 and 25

- If your will leaves assets to *your own children*:
  - So that they will become absolutely entitled at an age between 18 and 25 (but no later) to:
    - The assets
    - Their entire income and
    - All accumulations of such income
  - And all income and capital used whilst they are under 18 either cannot be applied for anyone else, or are in practice only used for them

There will be *no additional IHT charge* for each child up to their 18<sup>th</sup>, but there *will be from their 18<sup>th</sup> to their 25<sup>th</sup>*

- **That's a new IHT charge.**

Note that trustees can have no flexibility as to how to share out the income and capital between your children.

### Trusts for:

- *Your own children; or*
- *someone else's children (e.g. your grandchildren)*

**on terms that they will receive an income only interest at 25, through to their deaths or some specified older age**

- This has been dealt with above, at the bottom of page 3. If your Will leaves assets so that the relevant children (yours or those of other people) will become entitled at a specified age over 18 to the income but not the capital, there will be *an additional IHT charge* for each child both in the period up to their 18<sup>th</sup> and beyond, until the assets pass to them outright. There will be *no CGT charge* unless they become entitled to the capital outright before they die.
  - **That's a new IHT charge, especially disadvantageous where the life tenant is young, but potentially a new CGT benefit.**

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## A POSSIBLE SOLUTION TO THE WORST CASES, FOR YOUNG CHILDREN

We have highlighted the heavy IHT charge (albeit with some CGT advantages) that will arise where clients with significant wealth want to protect their (or someone else's) children by the use of life interest trusts in their Wills. Many people have used these, and we continue to advocate them because they can be an answer to concerns about wealthy youngsters, prey to drugs, alcohol, inappropriate relationships, divorce, bankruptcy and so on.

Without a re-structuring of their Wills, IHT will be payable at 40% on the client's death, and then at 6% every ten years for possibly a whole generation – say 60 years – which almost doubles the IHT charge to 76%. That is similar to the overall tax charge under the old regime (the child's own estate would be taxed at 40% on their own death). The difference is in cashflow, in that the decennial charges have to be met as they arise, there is no delay in payment of the second tranche of IHT as there was.

A new form of trust is evolving, which removes the decennial IHT charges and re-instates the old regime, and we can advise further in specific cases if desired.

### THE NEW RATES OF IHT

- Where a new IHT charge arises, on the commencement of new trusts, IHT will often be payable at 20% on the value of the trust assets on creation.
- Otherwise, or in addition, IHT is going to be payable at regular intervals during the period of the relevant trust's existence:
  - In most cases at up to 6% every 10 years starting from creation of the trust, and pro rata for shorter periods; and
  - Also usually at up to 6% on the occasion when assets leave the trust.
- The calculation of the IHT charge in most cases is complex and artificial, and requires access to your personal history of lifetime gifting. Please try to keep those records in a place where they can be found!

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This note deals only with the terms of Wills, not lifetime trusts and settlements. Of necessity, it is simplistic in approach and not exhaustive.

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