Inheritance Trust Case Study – Tom & Helen

Tom and Helen have recently sold the family home and moved to a comfortable bungalow, nearer to their daughter, who was their only child. As a result of the move they have realised around £200,000 of surplus equity, and are looking for advice about investing the money. Tom has a good pension from the NHS and Helen has a small Teacher's pension. Together with their state pensions they now have around £32,000 p.a. of secure income all fully indexed with inflation. They already had cash reserves of around £40,000 being the balance of Tom's tax free lump sum from the NHS after clearing the residue of the mortgage on their last home. It was recommended they keep this as their 'emergency fund'. Their stock market portfolio of around £220,000 is mainly held in Helen's name for tax reasons. Between the dividends from this and their pensions they have comfortably as much income as they need, especially as their domestic costs are now far lower.

Helen is five years younger than Tom, and has had some heart trouble although not immediately life threatening. Tom's main concern was that Helen might be left short of income after his death, as his NHS pension would reduce by 50%. However they also wanted to take some action to reduce any Inheritance Tax. Their combined estates are around £700,000 including their new found cash reserve.

After a meeting with them and their solicitor we proposed that a capital drawdown trust be established with the 'spare' cash passed to the trust by way of an interest free loan in Tom's name. On of the options that was discussed with them and their solicitor was whether the trust should be established as an 'absolute' trust, to avoid any possibility of a periodic charge to IHT. However, on the basis that any periodic or exit charges would be minimal it was decided this was to be established as a discretionary trust to give the trustees the maximum freedom in who should ultimately benefit, as her daughter and her husband had two children of their own.

It was agreed that Tom and Helen would act as the initial trustees and appoint their daughter and their solicitor as co trustees. It was also proposed that they leave the trust fund to grow in value, in the knowledge if it became necessary they could instruct the trustees to pay back them some capital, as the terms of the Loan Agreement stipulated that the loan was repayable on demand.

The first advantage of the proposed arrangement was that it effectively would 'freeze' the value of the capital for Inheritance Tax purposes at the £200,000 level, and any investment growth would automatically be outside their estates, being the beneficiaries' share of the trust.

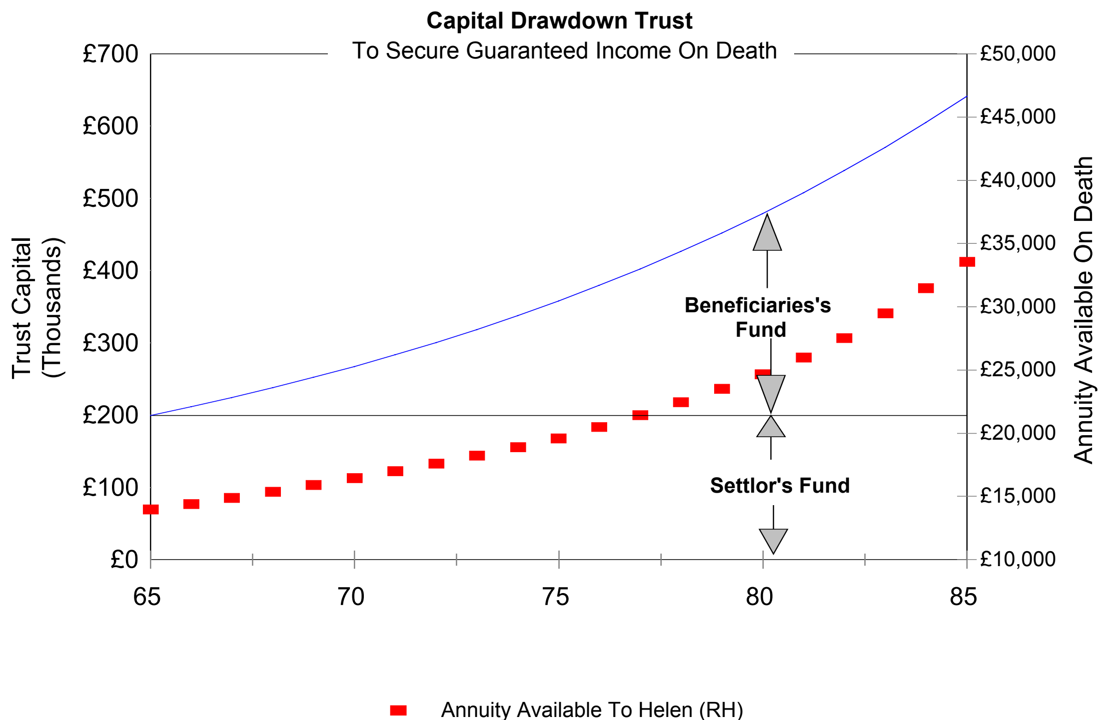
Secondly, the trust fund could be liquidated following Tom's death to enable the trustees to repay the £200,000 to Tom's executors, if requested to do so. The trustees would then decide what to do about the beneficiaries' share of the trust as a separate matter.

The cash from the capital repayment to the estate would then be passed back to Helen under the terms of his will, although if it were appropriate Helen would have the alternative option of requesting that the loan remain in place with the Trustees repaying the capital to her in instalments.

From a purely practical standpoint, Tom wanted Helen to have as little to deal with in terms of paperwork and tax returns as possible, and his stipulation was that as far as possible the income being paid into the bank each month should be enough to meet the normal bills. Their stock broker would continue to look after the portfolio and dividends would be credited into her high interest bank account to keep that topped up for meeting irregular outlays such as holidays, Christmas etc .

When we explained how the trust worked Tom's initial concern was that the 'real value' of the £200,000 capital would diminish over the intervening years due to the effects of inflation. However we explained to Tom and Helen that Helen could use the capital to secure a guaranteed income
through an Immediate Annuity, and that the longer Tom survived, the better the annuity rate would be for Helen. It was also explained that as a further precaution, Helen would be included as a potential beneficiary under the trust from the outset and could therefore obtain access to additional capital out of the beneficiaries' share if that became necessary.

The effects of this 'back to back' arrangement are shown below, where it can be seen that based on market annuity rates remaining generally at their current level the £200,000 capital would secure an ever higher income the longer the capital payout was deferred, and that by the same token the beneficiaries share of the trust capital would continue growing with ever rising IHT saving achieved.



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Reference - CS10

Tom was also reassured by the fact that the initial capital was repayable on demand, should there ever be the need to access this during his own remaining lifetime. From an income tax standpoint we explained that as the annuity would be secured from capital, most of the annuity payments to Helen would be tax free. Once the annuity was bought the income would be guaranteed for the remainder of her life. The second stage would remain optional and be subject to consideration at the time, particularly depending on Helen's own health. However the main objectives of mitigating Inheritance Tax while making additional provision for Helen in the form of a secure income after Tom's death would be achieved.

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