Scotland On Sunday

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Will Power Alone May Not Be Enough

Following a change in Inheritance Tax legislation the value of an estate that can pass free of tax to the family on the death of a surviving parent has increased to £624,000, double the rate previously available. The change, which enables any unused part of the nil rate threshold from the first death to transfer to the survivor, could potentially save up to £125,000 of tax at current rates. At first sight it looks too good to be true, but what does it mean in reality?

The new rule was rushed out in response to the Conservative party's proposal to raise the threshold for Inheritance Tax to £1 million. In fact, much the same effect was already able to be achieved using a 'nil rate band will trust'. Rather than the whole estate passing to the surviving spouse (or common law partner), any amount up to the nil rate threshold would be diverted into a family trust on first death.

This was achieved by an amendment to the wills, generally with mirror provisions for each spouse, to give the same effect whichever partner died first.

Since the survivor might still need some of the money, the trust normally would allow trustees to lend money back to the survivor as and when required to meet his or her financial needs. This had the added advantage of building up a debt against the survivor's own estate to further reduce the value potentially liable for Inheritance Tax on the second death.

There are still practical reasons why the 'nil rate band will trust' could be of greater benefit rather than the transferable nil rate band. For example where there are children from a previous marriage. Rather than the survivor having complete control over the distribution of the combined estate, potentially to the detriment of their deceased spouse's family, some or all the capital would pass into a trust specifically for the benefit of the deceased's family.

This form of will planning was relatively easy to achieve where the estate included a large enough element of free or realisable capital. If the estate was mostly in the form of heritable property such as the family home and little else, then rather more complex arrangements were needed, but still achieving the same effect. The objective in all cases was to make use of both spouse's nil rate bands, rather than just that of the surviving spouse.

One advantage of the new legislation is that it may be simpler where the family home makes up the vast majority of the estate. But on those cases where there are liquid assets as well, such as investments or cash, relying too heavily on the transferable nil rate band could be a mistake.

The pressure on government to raise the Inheritance Tax threshold on the back of house price increases will not be a factor for the foreseeable future due to a flattening property market. For that reason alone it will probably rise at a much lower rate than it has over recent years, at least under the present government. Leaving everything to the survivor on first death - rather than extracting some capital at that time - could give rise to unnecessary tax on the second death, if the value of the transferred estate increases by more than the rise in the threshold.

It is obviously desirable that any invested capital should continuing grow in value but any net gain above the rise in the threshold would potentially suffer Inheritance Tax at 40% on the second death. One way around this would be for the survivor to set up a 'loan trust' for that part of the estate that is in liquid form or readily realisable. The taxable value of the capital is then fixed in time, with any growth being outside of the survivor's estate for tax purposes, and retained in the trust for the beneficiaries.

To achieve this the capital is placed in trust as an interest free loan rather than an outright gift. The 'principal' remains in the ownership of the individual and the loan is repayable on demand giving access to part or all of the capital should it be needed. Usually these arrangements are documented to have

annual loan repayments which the investor uses to supplement their income. If set up correctly the draw down is tax free, for example a £300,000 trust could provide a £15,000 p.a. tax free ‘income supplement’.

Although the introduction of the ‘transferable nil rate band’ is welcome, it should not be relied upon alone if you have combined taxable estates in excess of twice the IHT threshold - currently £312,000 per spouse, or if you have substantial liquid capital that you want to see growing in value.

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