

## **The Journal Online**

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### **IHT: spouses and the nil rate band**

The value of an estate that can pass tax free to family heirs on the death of a surviving parent has doubled to £624,000, following a change in inheritance tax legislation that allows any unused part of the nil rate threshold from the first death to transfer to the survivor. This change means that up to £125,000 of tax could potentially be saved at current rates.

But whilst the introduction of the transferable nil rate band is welcome, it should not be relied upon solely if couples have combined taxable estates in excess of twice the IHT threshold or where they have substantial liquid capital which they wish to grow in value.

Although the new rule has been introduced by the government to counter opposition proposals to raise the threshold for inheritance tax to £1,000,000, much the same effect could have been achieved using a nil rate band will trust whereby, rather than the entire estate passing to the surviving spouse, any amount up to the nil rate threshold would have been diverted into a family trust on first death.

This was achieved by an amendment to the wills with mirror provisions for each spouse to give the same effect whichever partner died first. Since the survivor might still require some of the money, the trust would typically allow trustees to lend money back to the survivor as and when necessary 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 remain practical reasons why the nil rate band will trust could potentially be of greater benefit than the transferable nil rate band, for example where heirs include children from a previous marriage. In such circumstances, 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 of the capital would instead 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 sufficient element of free or realisable capital. If the estate was mostly in the form of heritable property, then more complex arrangements were needed, but the same result could still be achieved. The objective in all cases was to make use of both spouses' 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 comprises the vast majority of the estate. But in those cases where there are liquid assets too, such as investments or cash, relying too heavily on the transferable nil rate band could be a mistake.

A flattening property market will ease the pressure on the government to raise the inheritance tax threshold on the back of rises in house prices and, for that reason alone, the threshold will probably rise at a lower rate than it has done over recent years. This means that 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.

Whilst it is clearly desirable that any invested capital should continue to grow in value, any net gain above the rise in the threshold would potentially suffer inheritance tax at 40% on the second death. A solution to 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 residing outwith 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 his or her income. And if set up correctly, the drawdown is tax free.

### **Domicile issues**

One particular question that has only recently been raised concerns the application of the nil rate band rules to spouses who are non-UK domiciled, of which there are a growing number.

When an individual is UK domiciled, all their worldwide assets are taken into account for IHT purposes. If they are non-UK domiciled, only the assets situated in the UK come into the IHT net. When people emigrate, they will often wish to acquire a new domicile of choice and, if they do so, this may well result in an IHT saving on their subsequent death. The downside to having a foreign domicile, however, is that the spouse exemption for IHT on transfers to the non-UK domiciled spouse is limited to £55,000.

Consider the following scenario. Mary and her husband left the UK 20 years ago to retire in Spain. They never intended to come back to the UK and acquired a domicile of choice in Spain. However, Mary's husband died three years ago and soon after that Mary became ill. She continued to live in Spain, but last year the illness became terminal and she returned to England for treatment and to spend her last days with her family. Following her recent death her children are trying to sort out her estate. Given that she returned to the UK it is likely that her domicile of origin was revived.

Mary's husband left everything to her. If they were both UK domiciled at the time of his death there would have been no IHT due to the spouse exemption. If Mary was UK domiciled at that time, her husband's full nil rate band can be transferred to Mary.

However, if at that time Mary was not domiciled in the UK, the exempt amount would have been only £55,000 and any bequest above this amount would have fallen within his nil rate band, so reducing (possibly to nil) the proportion of the nil rate band available for transfer. The key message is that questions about domicile must always be asked when making transferable nil rate band calculations.

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