

NRB discretionary trusts and will planning (Lecture P1345 – 13.00 minutes)

It used to be common to find that nil rate band discretionary trusts were found in wills of married couples or civil partners. Note that the remainder of the narrative below will refer to spouses for ease of writing, but this applies equally to civil partners.

A nil rate band discretionary trust refers to a trust with value entering the trust equal to the nil rate band existing at the time of death.

The idea was that a nil rate band discretionary trust was created on the first death with the balance of the estate being left to the surviving spouse. No inheritance tax (IHT) would be due as the inter-spouse exemption would remove any charge on the assets above the nil rate band. More creative planning was sometimes used where the main asset was the family home but that is not considered further in these notes.

Such planning became less relevant when FA2008 introduced a new provision which enabled any unused nil rate band to be transferred to a surviving spouse so that there was not the loss of the nil rate band when the entire estate was left to the spouse on the death of their partner. It applies for a second death on or after 9 October 2007 regardless of when the first spouse died. It works on the basis of the percentage of the nil rate band used on the first death with the remaining percentage being applied to the nil rate band at the date of the death of the second spouse.

For example, if an individual died at a time when the nil rate band was £200,000 who left an amount of £50,000 in a non-exempt transfer on their death, they would have used 25% of their nil rate band. If the second spouse died at a time when the nil rate band was £325,000, they would have a nil rate of £568,750 being £325,000 plus ($£325,000 \times 75\%$).

It was perhaps prematurely suggested at this stage that nil rate band will trusts would become obsolete but are there any occasions when they can still be useful in the context of IHT planning?

Some examples of situations where it may still be useful to use these are as follows:

- To hold assets where increase in value may be greater than increase in value of NRB
 - Particularly relevant currently where no increase in NRB for significant period, and frozen until at least 2026
- To protect assets, particularly against care costs or other third parties
- To reduce estate of spouse so no restriction of RNRB
- Where either party is entitled to a transferrable nil rate band from a former spouse
- Have assets eligible for BPR or APR where that relief may be lost (either by change in use or by change in legislation)
- Where complex situations such as second marriages and stepchildren

It should be noted that in each of these situations, the same could be achieved by leaving assets to other individuals but it is acknowledged that this may not always be appropriate to do as there are circumstances where trusts are more flexible or useful to a family in the context of forward planning.

Example where increase in value

A husband has estate worth £500,000 including land he owns solely that is worth £100,000 which is likely to get planning permission although this is not certain at the time of death. The wife also has an estate which is worth £500,000. The husband dies leaving the land into a discretionary trust with the balance of the estate going to the wife.

By the time the wife dies, whilst she has not seen any increase in the value of the assets that she has inherited (or that she held in her own right), the land is now worth £2m.

At both deaths, the nil rate band is £325,000 and the residential nil rate band is £175,000. It is assumed that there is a residential property in the estate which can benefit from the residential nil rate band.

On the first death, no IHT would arise. This is also true if the entire estate was transferred to the wife, so no tax saving is achieved on the first death.

On the second death, if all the estate had gone to the wife, she would now have an estate of £2,900,000 (being £500,000 of her own assets plus £400,000 from her husband plus £2m for the land). She would not benefit from her own nil rate band as her estate is more than £2m. Her nil rate band would be £325,000 x 2 (as she would get the full nil rate band transferred from her husband) but would lose all the residential nil rate band due to the size of the estate. The total nil rate band would be £650,000 and the IHT due on the balance would be £900,000.

If £100,000 had been left to trust, her estate would have been £900,000. Her nil rate band would be £325,000 (own NRB) plus £225,000 (transferred from husband) plus 2 x £175,000 (the two residential nil rate bands), totalling £900,000. No IHT would be due.

Although the trust has its own IHT to pay, the land could be extracted without tax to pay if this can happen before the 10-year charge is due, on the basis that the initial value is less than the nil rate band and that any capital gain could be held-over under s260 TCGA 1992.

Example with former spouses

Tim is currently married to Susan but was previously married to Sarah who died whilst they were still married. Sarah left the whole of her estate to Tim so that he is entitled to her nil rate band on his death.

There are potentially three nil rate bands, but any one person can only claim a maximum of two nil rate bands:

1. Tim's nil rate band from Sarah
2. Susan's nil rate band
3. Tim's nil rate band (which can be transferred to Susan if he does not use it)

If Tim leaves his entire estate to Susan, then she will only get her own nil rate band and Tim's nil rate band, but Sarah's nil rate band will have been wasted.

If Tim left a nil rate band legacy into a discretionary trust, that would use the nil rate band from Sarah but still leave the whole of his nil rate band to be transferred to Susan. This is because we do

not start with £650,000 available, £325,000 used so only 50% of his nil rate band available to transfer.

Instead, we start with the fact that he has unused nil rate band of £325,000 meaning that he has 100% of the normal nil rate band unused.

If Tim had not been married before, but Susan had (and was entitled to a transferrable nil rate band from her previous husband) and Tim dies before her, the same route would be beneficial. He uses his nil rate band by using a discretionary trust as Susan already has the maximum nil rate band by inheriting the nil rate band from her first husband.

In both cases, you get the use of all three nil rate bands.

If Susan died first, in both scenarios she should also leave a legacy to a nil rate band discretionary trust. In the first situation, Tim cannot use her nil rate band as he already has the top-up from his first wife. In the second situation, it is the same position as in the first scenario but from Susan's perspective.

Example: protection against care costs

An individual has an estate of £500,000 but has a spouse who has been diagnosed with Alzheimer's disease and will therefore need care if he dies first. The spouse has low levels of personal assets as the affairs have been arranged in such a way due to the illness of the wife. The estate is well within the combined nil rate bands of the couple and so it may seem that no planning is needed to save IHT.

However, if he leaves £325,000 into a nil rate band discretionary trust, that value will be protected from care home costs for the surviving spouse and the surviving spouse can be beneficiary of that trust so they can benefit if necessary.

This has been seen in practice on a number of occasions and allows subsequent generations to benefit from part of the parents' estate.

Contributed by Ros Martin