

IHT planning – Nil rate band, life policies and excluded trusts

(Lecture P1099 - 19.06 minutes)

The use of a Discretionary trust – during lifetime, to gain a second nil rate band

Discretionary trusts are very often used in tax planning. All individuals have a nil rate band before they have exposure to inheritance tax on their death, as follows:

- From 6 April 2009 - £325,000;
- This has now been frozen until April 2021.

It is possible for an individual to gift this amount into a trust and so reduce their own wealth for inheritance tax purposes. Should the individual survive seven years, the settlor will then escape inheritance tax on the lifetime gift and will then also be entitled to a further nil rate band that could be utilised against their remaining wealth.

The discretionary trust is a useful vehicle to enable the settlor to gift property into trust and away from their own estates, but still have a certain amount of control over the assets as a trustee.

These are trusts that are established by law and would be expressly created via a trust deed.

If there is a couple, for instance high net worth individuals, they may consider both of them setting up a nil band trust, this is potentially removing $£325,000 \times 2 = £650,000$ from their estates after seven years. If they repeat the planning after seven years, this could amount to £1,300,000. An IHT saving of £520,000!! And again, in a further seven years – in the period of a little over 14 years, it is possible to utilise three nil rate bands per person.

The tax planning can also be extended by remembering to use the annual exemptions at the time of setting up the trusts or adding in property after the seven years – 2 x annual exemptions = £6,000 which adds an initial tax saving of £2,400. For a joint couple, this would be £4,800. Over the 14 years, the tax saving created by using the annual exemption amounts to $£3,000 \times 40\% \times 14 \text{ years} = £16,800$ per person.

A couple can be joint settlors of a single settlement without there being any IHT downside – s44(2) IHTA 1984 states that in a case such as this each will be treated as creating a separate settlement for the purposes of the tax charges.

Avoid the situation where a couple are joint settlors but all the funds come from one sole source as this could appear to be a sole settlor in the eyes of HMRC.

Life policies in trust

The proceeds of a life policy that are paid out on an individual's death would usually be part of the estate and included with the other assets. This then increases the total value of the assets on which there could be an inheritance tax charge.

Once the IHT threshold has been exceeded, the rate of tax charged at death is 40% and this is a considerable chunk of the estate and can often deplete the value left for the beneficiaries named in a will, or that would benefit on intestacy.

One method of tax planning is to assign (place) the life policy into trust. If this is done, the amount paid out on the insured's death is not included in the value of the estate. The value is diverted away from the estate and passed directly to the named beneficiaries, thus avoiding a potential 40% tax charge.

Another advantage to putting a life policy into trust is that anything paid out on death from the policy will not be included in the estate, and will not therefore be tied up until probate is granted. Therefore, the policy can be useful to pay expenses that are necessary at the time of death, in order to help the probate process be carried out more smoothly, such as paying for a funeral, paying the IHT etc.

In addition, this is a useful tool to leave value to individuals without having to share other assets between beneficiaries that might be impractical, or impossible, to divide.

Discretionary trusts are usually used when writing life policies into trust. They give greater scope of beneficiaries and tend not to be as limiting, depending of course on the wishes of the settlor and how the proceeds are intended to be used.

Placing a life policy in trust can be a simple matter and it would entail initially contacting the insurance provider. The policy can then usually be put into trust by the completion of a form that the insurance provider will supply. The form details the name of the policyholder, the name of the insured, details of the beneficiaries and such like, and is not usually a complicated process but can gain much benefit.

Example

Marion had a life insurance policy in place during her lifetime, into which she paid regular premiums each month. On her death, the policy would pay out £50,000.

Marion already owned assets to the tune of £500,000.

She has two options.....

1. Assign the insurance policy into trust and therefore into the hands of the trustees, or
2. She doesn't assign the policy into trust

If Marion were to die during 2016/17, the effect of these two options are as follows:

Under option 1, the insurance proceeds of £50,000 are paid out directly to the trustees and are not included in her estate for IHT purposes. Her IHT liability is therefore £500,000 less £325,000 nil band = £175,000 at 40% = £70,000

Under option 2, the insurance proceeds of £50,000 are added to Marion's estate and the IHT liability is as follows: £500,000 + £50,000 = £550,000 less £325,000 nil band = £225,000 at 40% = £90,000.

Therefore, it can be beneficial from a tax point of view to write insurance policies into trust.

Excluded Property Trusts

A transfer of overseas property into a trust, by a non-UK domiciled individual will not trigger an inheritance tax charge, as this property is 'excluded property' while the individual is non UK domiciled, in accordance with the legislation at s48(3) IHTA 1984.

In addition, it is possible for the non-UK domiciled individual to still be able to benefit from this trust property and retain the inheritance tax advantages as, although normally the gifts with reservation of benefit rules would usually kick in when a settlor enjoys the property he has given away, the legislation at s48(3) for excluded property takes precedence over the GWROB legislation. If any benefit is retained, it should be noted that the trust would be a settlor interested trust for income tax purposes and the income would be assessable on the settlor.

Excluded property trusts are still an effective form of inheritance tax planning for non-UK domiciled individuals with overseas property.

Be sure to consider the tax planning before the individual becomes deemed domiciled in the UK.

If an individual is no longer able to set up an excluded property trust, consider diverting wealth into the hands of other non-UK domiciled family members that have not yet become deemed domiciled in the UK.

Contributed by Amanda Fisher