

Inheritance Tax, the Transferable Nil-Rate Band and the Nil-Rate Band Discretionary Trust

This guide is intended for

- married couples, civil partners, or their children, who want to understand how the Transferable Nil-Rate Band works, and how it might effect them or their family
- married couples or civil partners who are both still alive and who have made Wills which include a gift to someone else when the first of the couple dies, especially (but not only) a gift of the nil-rate band to a discretionary trust,
- a widow, widower or surviving civil partner, especially (but not only) whose late spouse or civil partner made a gift on death to someone else, and especially (but not only) a gift of the nil-rate band to a discretionary trust, whether by Will, intestacy or deed of variation, and
- anyone whose Will includes a gift of the nil-rate band (for instance, “the largest amount I can give without Inheritance Tax being paid”).

[The Inheritance Tax (IHT) nil-rate band is the amount up to the IHT threshold. It is called this because tax is technically charged on it, but at the rate of ‘nil’ %. It is currently a maximum of £325,000.]

Once you have read this guide, you should complete the checklist at the end, which will help you to decide what to do next.

In the remainder of this guide, the word “spouse” is used for brevity, but should be read as “spouse or civil partner”.

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Why all this Matters – the Inheritance Tax Trap

To recap what has gone before: looking at the ‘standard’ family Will – all to surviving spouse, then all to children – the IHT implications before 9th October 2007 were that when the first spouse died, there would be no IHT on anything passing to the surviving spouse, who was an exempt beneficiary.

However, all the couple’s assets (and any pension lump sum, insurance policy proceeds or death-in-service benefit which was paid on the first death) would then be held by the survivor. When the survivor died, the normal rules would apply; after the nil-rate band, everything would be taxed at 40%, which could result in a significant IHT charge.

In these typical family Wills, the nil-rate band was used on the second death only. There *was* a nil-rate band available on the first death as well, but everything was passing to the surviving spouse (who was exempt at that stage, but in whose estate it would be taxed on the second death) so that first nil-rate band was not used – it was wasted.

The Classic Solution – the Nil-Rate Band Discretionary Trust

To prevent that waste and to lock-in the first spouse’s nil-rate band, many people arranged that when the first spouse died, the amount of that spouse’s nil-rate band – by definition, the largest amount which can be given away without having to pay IHT – was given to a trust, and the residue to the surviving spouse. If the trust then lent its assets to the surviving spouse, he or she held all the assets but owed a large debt to the trust.

If this was done properly then, on the survivor’s death, the debt owed to the trust reduced the value of the estate (by the amount of the first spouse’s nil-rate band), then the survivor’s own nil-rate band was deducted, then IHT was charged on what was left. The net estate and the trust money both then passed to the children. This effectively caught and preserved the use of the first spouse’s nil-rate band, which would otherwise have been lost.

This is the Nil-Rate Band Discretionary Trust (NRBDT) mechanism **and it continues to work** exactly as described, delivering exactly the same tax-saving benefit it always did. If you have NRBDT Wills, and that is enough to cover the likely value of the survivor’s estate in your case, there is no need to change anything.

The New Regime – the Transferable Nil-Rate Band

However, a new Transferable Nil-Rate Band (TNRB) mechanism which became law in the Finance Act in the late summer of 2008 and took effect retrospectively as from 9th October 2007, can now give a roughly equivalent tax saving.

To explain: if we go back to the standard family Will, when the first spouse dies and everything passes to the survivor (an exempt person), the first spouse's nil-rate band is 100% unused. Previously it was wasted, unless we used the NRBDT to lock it in. Now, under the TNRB rules, when the surviving spouse dies after 9th October 2007, the executors of the survivor's estate can apply to have that unused percentage transferred to the second estate.

The value of the first spouse's estate doesn't matter, only the percentage of the nil-rate band unused. That percentage *of the nil-rate band in force at the date of the second spouse's death* is then added to the second spouse's own nil-rate band.

NRBDT v TNRB – which is worth more?

This is difficult to predict.

As the level of the nil-rate band usually goes up each year, and as it is the higher nil-rate band applying at the later date of the survivor's death which is multiplied by the unused percentage, it looks as though the TNRB should deliver greater tax saving than the NRBDT, as long as the survivor outlives the first spouse at least into a new tax year. However, it is not quite as simple as that.

The nil-rate band is now frozen at £325,000 until 6th April 2015. When it does start going up again each year, that increase will now (from 6th April 2011) be calculated by reference to the government's newly-preferred measure of inflation, the Consumer Prices Index, or CPI, rounded-up to the nearest convenient number. This is preferred by the government because it is significantly lower than the traditional measure, the Retail Prices Index, or RPI.

On the other hand, the debt owed by the surviving spouse under the NRBDT will usually be expressed to be index-linked at the point at which the debt is called-in, so that it will increase in line with inflation, and the link is always to the higher RPI.

The difference in IHT saving between the two schemes is therefore now very hard to predict and probably marginal. If you have NRBDT Wills now, there is no compelling tax reason to drop them and rely on TNRB instead. If you are thinking of making new Wills or changing your existing Wills, then it will certainly be simpler to rely on TRNB than to incorporate NRBDTs.

NRBDT v TNRB – other considerations

However, for some people with a NRBDT, tax-saving was not the only or the main reason for creating it – some wanted to use it to channel the amount of the nil-rate band to specific beneficiaries, or to protect assets from recovery of residential care charges. If that was so in your case, we need to look at these motives – it might be appropriate to keep the NRBDT, but we might now be better off using a different type of trust, to achieve the same ends while preserving the entitlement to TNRB.

If you want to make substantial gifts when the first of a couple dies, to people other than the surviving spouse, there is a similar mechanism we can use to allow these gifts to be made soon after the first death without eating into the first-death nil-rate band and so limiting the amount of TNRB. They take effect instead as gifts by the survivor, but do not rely on the survivor to make them.

Also, if one of you has previously lost a spouse, you may already have an entitlement to TNRB, and we should definitely still use a NRBDT to preserve the benefit of that additional entitlement, which will otherwise be lost.

Finally, if one of you owns qualifying business assets (if you are in business as a sole trader or a partner, or own shares in an unquoted trading company or AIM-listed shares) then there is still an opportunity to use a trust to save IHT.

No Need to Rush – the Wait and See Option

The two mechanisms are mutually-exclusive – if you have a NRBDT, that uses up the available nil-rate band, and what is used up cannot be transferred under the TNRB.

Fortunately, it is not necessary to rush to a decision. In the same way that a deed of variation effectively allows a Will to be re-written within two years after death, a parallel mechanism allows a trust to be altered or cancelled after death, with retrospective effect for IHT purposes.

That means that if you have NRBDT Wills, you could choose to leave them as they are; then, when the first of you dies, the survivor has a period of two years after the death within which to adjust to the new situation and to assess his or her circumstances and intentions. If it turns out that the NRBDT was not appropriate and that the TNRB route would have been preferable, the NRBDT can be wound up.

As long as the NRBDT is wound up within the two year period after death, that winding-up has retrospective effect for IHT purposes (as if the NRBDT had never existed), allowing reliance to be placed instead on the TNRB.

Equally, if you do not have NRBDT Wills and, after this process of adjustment and assessment, it appears that the NRBDT or some other form of trust would have been better for you, it can effectively be written into the Will by a deed of variation made within two years after the death, with retrospective effect for most tax purposes, as if it had been included in the Will in the first place.

[The Effect of Lifetime Gifts

Both the old NRBDT and the new TNRB depend on the level of nil-rate band available on the first death and, for completeness, you should know that the level of nil-rate band available on a person's death depends upon the total of certain types of gift made by that person in the seven years before death.

There are some types of gift (those covered by the annual allowance, the carried-forward annual allowance or the small gifts allowance, and those made for family maintenance, in contemplation of marriage, as part of normal annual expenditure from surplus income, of exempt assets, to an exempt person, for national purposes or for public benefit) which are out of reach of IHT as soon as they are made.

Every other lifetime gift is technically a Potentially-Exempt Transfer (PET) or a Chargeable Transfer (CT) and it drops out of the IHT calculation on death only if the person making the gift lives for more the seven years after making it. If the person making the gift dies within seven years after making it, the PET or CT effectively eats into the nil-rate band available on death.

(You may come across references to Taper Relief, which can reduce the IHT impact of a gift progressively, starting after just three years. This is much more complex than is generally described. It can only apply to very large gifts – several hundreds of thousands of pounds – and its effect is then only marginal. Ignore it.)]

If Your Spouse has Already Died

- If your spouse died *within the last two years*, whether or not there was a Will, anyone who inherited any of the estate can redirect what they inherited, using a deed of variation signed within two years after the death. If it is done properly, and within the time limit, the alteration made by the deed of variation takes effect for most tax purposes as if that is how things had been left in the first place.

This may be relevant to you for a number of reasons:

- if your late spouse's Will made a significant gift to someone other than you, or made a gift of the nil-rate band to a discretionary trust without the necessary powers to index-link the loan to the surviving spouse;
- if you were, or your late spouse was, previously married and that earlier marriage ended with the death of the other party, or
- if your late spouse owned certain qualifying business assets.

In any of these circumstances applies to you, a deed made within two years after your spouse's death can be used to save a great deal of IHT on your death.

If your spouse died less than two years ago, you need to see a specialist solicitor promptly, so that the opportunity to take appropriate steps within the two year period is not lost.

- If your spouse died *more than two years ago*, you cannot now alter how the estate was left. In that situation, if your spouse's Will made a gift of the nil-rate band to a discretionary trust, it is important that the gift is properly documented and the trust properly maintained, or the tax-saving effect of this NRBTD mechanism may be lost.
- If your spouse has died, whatever happened to his or her estate, whether by Will or (if there was no Will) under the Intestacy Rules, or by deed of variation (redirecting the estate after death), your executors may be able to claim at least some TNRB for the benefit of your estate on your death.

To make the claim, they need to produce, as a minimum, your marriage or civil partnership certificate and your spouse's death certificate. They then need to produce evidence to prove how much of your spouse's nil-rate band was unused. This depends on the circumstances, but would include a copy of the Will (if one was written) with any codicil or deed of variation which was made, the grant of probate or letters of administration (if one was obtained), and copies of any IHT papers and valuations filed (if available). The Revenue's requirements are much stricter where your spouse died after 9th October 2007, the date the TNRB was announced.

You can make that job easier for your executors by collecting that evidence now, and keeping it in a safe place. If there is no clear documentary evidence about what happened to your spouse's estate, you can sign a simple statement about what happened, and put that with your papers.

Gifts Defined by the Nil-Rate Band

Even a simple Will might be effected by the introduction of the TRNB. Some people include a gift in their Will using words like “the largest amount I can give without Inheritance Tax being paid”. Before 9th October 2007, for most people, this generally meant a maximum of £312,000. After 9th October 2007, if your spouse died before you, this could now mean more than double that figure. If this is relevant to you, we need to discuss your intention and look at changing the wording, if necessary, to give precise effect to that intention.

Joint Tenancies and Tenancies in Common

If you set up NRBDTs, you probably severed the joint tenancy under which you held your home, creating a tenancy in common. This does not need to be reversed, even if you cancel your NRBDTs. The tenancy in common is still generally necessary to ensure the maximum IHT saving if the two of you die at the same time (or within 28 days of each other).

What *Hasn't* Changed

- For couples who are not married and not in a civil partnership, and who want to leave assets to each other when the first of them dies, the NRBDT is still the only way to avoid a double tax charge when the second of the couple dies.
- Discretionary trusts are still the right tools to use for sheltering from IHT and from third parties (and sometimes from beneficiaries themselves)
 - particular types of business asset,
 - pension fund death payments,
 - company death-in-service benefits,
 - life policy proceeds,
 - most large inheritances and
 - many lifetime gifts.

In almost all cases, these trusts can be set up so that they can be run with minimal administration and, therefore, without potentially-expensive professional trustees.

IHT Efficiency Now

Finally, what should you do now for maximum IHT efficiency? That depends on your personal circumstances, and is rather different for the single person but, for a married couple or civil partners, in general, and in highly simplified form...

Make Wills which

- when the first of you dies, leave everything to the survivor,
 - *unless*
 - you hold particular types of business asset
 - you were, and / or your spouse was, previously married or in a civil partnership which ended with the death of the other party
in which case, include a preliminary gift of the 100%-IHT-relieved assets and / or the additional TNRB to an appropriate number of pilot trusts
 - *and unless*
 - you want to make substantial gifts to someone other than your spouse
 - you want to ensure that what you leave to your spouse will pass to specific beneficiaries after his or her death
 - you want what you leave to your spouse to be protected from people claiming against him or her
 - your spouse would not be capable of managing the inheritance
in which case, leave everything instead to carefully-selected and properly-instructed trustees to hold upon appropriate trusts for your spouse
- when the last survivor of you dies, divide the estate between an appropriate number of pilot trusts.

If you have life policy money which would pay out on death, assign or nominate the benefits to an appropriate number of pilot trusts.

If you have a company death-in-service or pension scheme which would pay out a lump sum on death, nominate or assign each such payment to a separate pilot trust, understanding and accepting the IHT consequences for a large fund.

If you have surplus

- capital, make use of the annual, 'small gifts' and 'gifts in contemplation of marriage' IHT allowances and exemptions
- income, make use of the 'normal annual expenditure from surplus income' exemption

in each case, preferably making the gifts to a trust.

If you have a lot of surplus capital, consider making a substantial gift to a trust, accepting or insuring against the risk of premature death.

If you inherit, use a deed of variation to re-direct the inheritance to a trust.

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Checklist – 1 of 2

Yes

I inherited (or will inherit) from someone who died within the last two years.....

You should contact Michael Cutler or his secretary on 01628 631051 without delay to arrange an urgent meeting to discuss whether any action should be taken within the strict time limit of two years after the death

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We have Wills which make a gift of the nil-rate band to a discretionary trust when one of us dies and the other survives.....

Your Wills and trusts are still perfectly valid, but there is now another way of doing things. We can look at making changes now, if you wish, but we do not need to, as the last survivor of the two of you can make any necessary changes retrospectively, within two years after the first of you dies, making decisions in the light of the circumstances applying at that time.

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When one of us dies and the other survives, we want to guarantee that some or all of the assets pass to specific people after the last survivor of us dies

When one of us dies and the other survives, we want to shelter assets from claims by other people or authorities while the surviving spouse is alive.....

I want to leave assets in a way which shelters them from Inheritance Tax and from claims by other people or authorities.....

I want to leave assets for somebody who cannot manage them, or cannot be trusted with them, or whose entitlement to benefits might be adversely affected

This can be done using properly-written Wills and trusts. You should contact Michael Cutler or his secretary on 01628 631051 to arrange a meeting to discuss the what you want to do.

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We are not married or in a civil partnership, and we want to leave assets to each other

I was in an earlier marriage or civil partnership which ended with the death of the other party ..

I am a sole trader, a member of a business partnership, or own shares in a private trading company, or AIM-listed shares

There is a pension fund lump sum, company death-in-service benefit or life policy which will pay out when I die, and which is not already nominated or assigned to a discretionary trust

We are married or in a civil partnership and have Wills which make gifts to other people when the first of us dies

There may be an opportunity to save a significant amount of Inheritance Tax. You should contact Michael Cutler or his secretary on 01628 631051 to arrange a meeting to discuss the matter.

**Inheritance Tax,
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Checklist – 2 of 2

Yes

I don't have a trust, but my Will includes a gift of the amount of the nil-rate band, or a gift defined with words like "as much as I can give without Inheritance Tax being paid"

Because of new tax rules, this may now have a very different effect from what you intended. This must at least be reconsidered, and may need to be changed, in the light of new tax rules. You should contact Michael Cutler or his secretary on 01628 631051 to arrange a meeting to discuss this.

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My spouse died over two years ago, and I'm not sure how the new rules effect me

My spouse died over two years ago, and I haven't sorted out the paperwork yet.....

I am confused and want to talk to somebody about all this

You should contact Michael Cutler or his secretary on 01628 631051 to arrange a meeting.