

## Trust and Tax Implications of Your Will

This help guide explains how inheritance tax (IHT) applies to an estate. It also details some of the more complicated trust and tax aspects of the provisions in your Will, though not all the factors discussed here will apply to all Wills.

We have outlined the current law relating to trusts and IHT. Our advice is based on the law as it is generally understood and considers accepted HMRC practice, interpretation, press releases and practice statements. It is important to understand that HMRC may change these without warning. They may also choose to announce changes to IHT and the taxation of trusts at any time.

It is very important to review your will and the value of your assets:

- At regular intervals, we recommend at least every five years
- Whenever there is a significant change in your circumstances

### Inheritance Tax

#### *What is IHT?*

IHT is essentially a tax payable on your assets after your death. This includes your share of assets jointly held with others. Lifetime gifts made in the seven years before your death can also be considered.

IHT is also payable on any assets that have been given away if you have retained the use of them. For example, if you transferred your house into your child's name but continued to live there yourself, IHT would still need to be paid on the value of the house after your death.

#### *IHT and nil rate band*

When you die, the IHT charge on your estate will be nothing up to the rate of the **nil rate band** and 40% on the remaining balance. The nil rate band is currently £325,000 and is set at this level until 5 April 2021. However, do remember that the value of any lifetime gifts given in the seven years before your death will count towards this threshold.

If you give your home to lineal descendants such as children and grandchildren, your estate can benefit from an additional residence nil rate band. If this applies, a further £100,000 to £175,000 of the estate could be taxed at 0%. You can also transfer unused residence nil rate band from a deceased spouse or civil partner.

If you are married or in a civil partnership, your surviving spouse or civil partner can inherit any unused portion of your nil rate band to reduce the IHT payable on their estate on their death. This portion will be represented as a percentage rather than a specific figure to account for the changing threshold.

## *Main exemptions for lifetime gifts and on death*

Certain gifts are exempt from IHT and do not use up your nil rate band. The main exemptions are:

- Gifts to your spouse or civil partner (the spouse exemption)
- Gifts to charities established in the UK (the charity exemption)
- Gifts that are made regularly out of surplus income

There is an important restriction on the spouse exemption where a UK domiciled person leaves assets to their non-UK domiciled spouse or civil partner. If you think that this may apply to you, please speak to us about it.

## *Potentially exempt transfers (PETs)*

An outright gift to an individual is potentially exempt from IHT and becomes fully exempt if you survive for seven years from the date of the gift. If you do not survive for seven years, the gift becomes chargeable to IHT.

If you survive for more than three years after the gift is given, it will then be subject to a sliding scale of 20–100% of the IHT charge.

## *Domicile*

If you are domiciled in the UK, you will be subject to IHT on all your assets, no matter where they are based in the world. If you are domiciled outside the UK, you will only be subject to IHT on your UK assets. Domicile has a specific legal meaning for UK tax purposes, it doesn't simply refer to your main place of residence. You may acquire a UK deemed domicile status for IHT if you have lived in the UK for a long time. If you're unclear about your domicile status, we can help you understand it in more detail.

## *Where does the burden of IHT fall?*

Where the burden of IHT falls – i.e. which assets will be used to pay it will depend on the extent of your estate and the provisions made in your Will.

## Trust summary

You may have established a trust in your Will to govern how your beneficiaries enjoy the benefit from your assets after you die. A trust arises whenever you give your assets to another person (the trustee) to hold for the benefit of someone else (the beneficiary).

### *Trustees' duties*

Trustees have various duties, including:

- Balancing the competing interests of all beneficiaries of the trust (this can be particularly difficult between beneficiaries of income and capital)
- Investing trust assets carefully with professional investment advice
- Completing and submitting annual self-assessment tax returns for the income and capital gains of the trust
- For discretionary trusts, completing and submitting supplementary tax returns whenever an IHT charge arises (see Discretionary trust)
- Running the trust properly, including holding regular meetings to decide what to do with the income and capital in the trust in any one tax year
- Keeping a full record of the decisions taken in trustee meetings

The three main types of trust that may arise in your Will are:

### *Life Interest Trust*

In a life interest trust, the entitlement to an asset is split into its capital and income elements. For example, if the asset is a share in a company, the capital is the share, and the income is the dividend that is paid out on the share. The beneficiary entitled to the income is called the life tenant. When their entitlement to the income ends, either on their death or after a specified period, the capital would then pass to the beneficiaries you specify.

For IHT purposes, the life tenant is treated as if they own the trust assets. When the life tenant dies, under a will trust, the assets in the life interest trust are treated as though they were part of the life tenant's estate.

### *Discretionary Trust*

In a discretionary trust, although the capital and income elements of the assets are still important, the trustees can distribute income and capital separately to beneficiaries, as the trustees see fit.

There are usually several beneficiaries (specified in your Will) who may benefit from the assets in the trust, but no beneficiary is absolutely entitled to either income or capital unless, or until, the trustees do something to create such an entitlement.

## *Bare trust*

In a bare trust, the beneficiary has an absolute entitlement to the assets, but the trustee holds the assets on the beneficiary's behalf. This kind of trust generally arises in cases where a Will makes a gift to a beneficiary who is under the age of 18. The trustees, therefore, hold the assets until the beneficiary can give a valid receipt for them.

## Your Will

### *Tax-efficient wills for spouses or civil partners*

Often, one of the primary intentions behind the provisions in a Will is to ensure that no IHT is payable when a spouse or civil partner dies. If that is your intention, you must make sure you restrict the total value of gifts in your Will (or in the seven years before your death, to non-exempt beneficiaries) to an amount less than the nil rate band.

A gift to your spouse, civil partner or to a charity is exempt. However, a gift to your children or grandchildren is not exempt. You can say in your Will that a gift of a specific asset, such as personal possessions, cash or a property is subject to IHT. This means that the proportion of tax due on that gift must be paid from the gift itself.

For example, if you give £5,000 to your son subject to IHT, a proportion of the IHT payable on your death must come out of that cash gift so that your son will receive the gift net of tax.

### *IHT on non-residuary gifts*

A non-residuary gift is any gift other than the main provisions dealing with your residuary estate, including:

- Gifts of personal possessions
- Gifts of money
- Gifts or trusts of real property
- A gift or trust of the nil rate amount

Unless these gifts specifically state otherwise, any IHT payable on the assets given in your Will is payable from your residuary estate.

## Gifts of personal possessions

### *Outright gifts*

The beneficiary is entitled to the assets from the outset and can deal with them as they think fit. The assets form part of the beneficiary's estate for tax purposes.

### *Gifts with a request to distribute*

The beneficiary is entitled to the assets from the outset. However, if (within two years of your death) the beneficiary passes any asset on in accordance with any wishes you make known, the onward gift is treated as though it was made by you in your Will (and not by the original beneficiary). Any assets not distributed in this way form part of the original beneficiary's estate for tax purposes.

### *Tax treatment of gifts*

The gift is exempt from IHT if the beneficiary is your spouse or civil partner, or a charity. However, any onward gifts of those personal possessions by your spouse or civil partner in accordance with a request to distribute are treated, for IHT purposes, as if made in your Will and the benefit of the IHT exemption is accordingly lost.

If the beneficiary is a non-exempt beneficiary (such as a child or grandchild), the nil rate band available to your estate is reduced by the value of the gift and your estate may be subject to IHT if the nil rate band is all used up.

### *Gift of real property: tax treatment*

The gift is exempt from IHT if the beneficiary is your spouse or civil partner, or a charity. If the beneficiary is a non-exempt beneficiary, the nil rate band available to your estate is reduced by the value of the gift and your estate may be subject to IHT if the nil rate band is all used up.

### *Trust of real property: tax treatment*

The property and any assets arising from it are treated for tax purposes as though they belong to the life tenant.

### *When life interest trust comes into effect*

If the life tenant is your spouse or civil partner, the spouse exemption applies to exempt the value of the property from IHT on your death. If the life tenant is a non-exempt

beneficiary, there is no exemption and the nil rate band available to your estate is reduced by the value of the property. If the nil rate band is all used up, IHT will be payable.

### *When life interest trust comes to an end*

If the life interest trust comes to an end on the life tenant's death, the value of the assets in this trust are treated as forming part of the life tenant's own estate for IHT purposes and are taxed accordingly.

If the life interest trust comes to an end while the life tenant is still alive, the life tenant is treated as making a gift of the assets in the trust. The tax treatment of that gift depends on the eventual beneficiaries of the trust assets, as follows:

- If the assets pass outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT.
- If the assets pass outright to non-exempt beneficiaries (such as your children or grandchildren), the gift is treated as a potentially exempt transfer (PET) by the life tenant.
- If the assets pass into a trust (either another life interest or a discretionary trust), the life tenant's estate is charged to IHT at the lifetime rate of 20%, to the extent that the value exceeds the life tenant's own available nil rate band

### *Right to occupy real property: tax treatment*

The right to occupy does not include any right to income arising from the property or its sale proceeds. However, the property is treated for tax purposes as though it belongs to the occupier.

### *When right to occupy comes into effect*

If the occupier is your spouse or civil partner, HMRC should treat the occupier as having a life interest and so the spouse exemption applies to exempt the value of the property from IHT.

If the occupier is a non-exempt beneficiary, there is no exemption and the nil rate band available to your estate is reduced by the value of the property.

### *When right to occupy comes to an end*

If the right to occupy comes to an end on the occupier's death, the value of the property is treated as forming part of the occupier's own estate for IHT purposes and is taxed accordingly.

If the right to occupy comes to an end in any other circumstances, the occupier is treated as having made a gift of the property. The tax treatment of that gift depends on the eventual beneficiaries of the property, as follows:

- If the property passes outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT.
- If the property passes outright to non-exempt beneficiaries (for example, your children or grandchildren), the gift is treated as a PET by the occupier.
- If the property passes into a trust (either a life interest trust or a discretionary trust), the occupier's estate is charged to IHT at the lifetime rate of 20%, to the extent that the value exceeds the occupier's own available nil rate band.

## Gifts of money

### *Beneficiaries under 18 years old*

If you make a gift of money to a beneficiary who may be under 18 years old when you die, the beneficiary is legally entitled to the income (although your trustees can hold it in a separate account for the beneficiary until they reach 18). The tax treatment is as follows:

- **Income tax:** the income is taxed as the beneficiary's income, with the benefit of the beneficiary's personal allowance and at the rates of tax that apply to them.
- **IHT:** this clause is drafted so there is no additional IHT to pay unless the beneficiary dies before reaching the specified age (in which case there is a potential IHT liability on the combined value of the cash gift and the beneficiary's own personal estate).

### *Gift of the nil rate amount*

This gift is made conditional on an IHT-exempt beneficiary (spouse, civil partner or a charity) inheriting your residuary estate, as there is no IHT-efficiency achieved by this type of gift otherwise. The gift is worded so that if your spouse or civil partner has already died, it does not take effect at all.

As the amount of your available nil rate band is likely to vary after you make your Will, your Will defines the nil rate amount broadly as the largest amount of cash you can give in your will without paying IHT.

### *Reducing the value of your gift*

The value of this gift is reduced by:

- All the non-residuary gifts made in your Will to non-exempt beneficiaries

- Any gifts made by you before your death where their value must be considered for IHT purposes

## *Increasing the value of your gift*

Depending on how the clause is drafted, the value of your gift may be increased by:

- Any transferable nil rate band from a deceased spouse or civil partner
- A proportion of the value of IHT relief given to assets in your estate that qualifies for agricultural or business property relief. (The application and interaction of these reliefs with the rest of your estate is very complex. If you'd like a more detailed explanation of the rules, please get in touch)

The beneficiary is entitled to the assets from the outset and can deal with them as they think fit. The assets form part of the beneficiary's estate for tax purposes. This is a much less flexible form of gift than a discretionary trust.

## *Trust of the nil rate amount: tax treatment*

This gift is made conditional on an IHT-exempt beneficiary (spouse, civil partner or a charity) inheriting your residuary estate. This means that where a will leaves the residuary estate to a spouse or civil partner and they die before you, this gift does not take effect at all. If you are planning to leave your residuary estate to a non-exempt beneficiary (such as a child or grandchild), the nil rate band trust will not be a tax efficient way to do this.

## *When the trust comes into effect*

As the value of the gift is the maximum gift of cash you can give away without needing to pay IHT, there is no IHT to pay when the trust comes into effect.

## *During the trust period*

In the two-year period following your death, your trustees can take advantage of some writing-back provisions to make payments out of the trust and for these to be treated, for IHT purposes, as though they were gifts made by you on your death. These provisions can be particularly useful for tax and succession planning, as your trustees can take account of all surrounding circumstances during that two-year period (including the relative financial and personal situations of all potential beneficiaries).

Discretionary trusts are subject to two additional types of IHT charge during their existence, at a maximum rate of 6% as follows:



- **Exit charges:** these charges apply when property leaves the trust. During the first ten years after your death, unless property is subsequently added to the trust, the rate for any exit charges should be 0%.
- **Ten-year anniversary charges:** these charges apply every ten years after your death. The amount of the charge is broadly based on; the value of assets in the trust on the ten-year anniversary, any assets left the trust in the preceding ten years and the settlement nil rate band (which is a separate tax free band that applies to any trusts you set up in your lifetime or in your Will) that is applicable on the anniversary date.

## Residuary estate

### *Outright gift to your spouse or civil partner*

Your spouse or civil partner is entitled to the residuary estate and can deal with it as they see fit. The assets in the residuary estate form part of their estate for tax purposes. The spouse exemption applies to the gift and there is no IHT to pay on the residuary estate.

### *Trust for your spouse or civil partner: tax treatment*

The assets in the residuary estate are treated for tax purposes as though they belong to the life tenant.

This happens:

- When life interest trust comes into effect: because the life tenant is your spouse or civil partner, the spouse exemption applies to exempt the value of the residuary estate from IHT.
- When life interest trust comes to end: if the life interest trust comes to an end on the life tenant's death, the assets in this trust are treated as forming part of the life tenant's estate for IHT purposes and are taxed accordingly. If the life interest trust comes to an end while the life tenant is still alive, the life tenant is treated as making a gift of the assets in the trust. The tax treatment of that gift depends on the eventual beneficiaries of the trust assets:
  - if the assets pass outright to an exempt beneficiary (such as a charity), the gift is exempt from IHT.
  - if the assets pass outright to non-exempt beneficiaries (for example, your children or grandchildren), the gift is treated as a PET by the life tenant.
  - if the assets pass into another trust (either another life interest trust or a discretionary trust), the life tenant's estate is charged IHT at the lifetime rate of 20%, where the value exceeds the life tenant's own available nil rate band.

## *Discretionary trust: tax treatment*

### *IHT may become due:*

- **When a trust comes into effect:** IHT is paid on any assets forming part of the residuary estate over the nil rate band.
- **During the trust period:** in the two-year period following your death, your trustees can take advantage of some writing-back provisions to make payments out of the trust and to have these treated for IHT purposes as though they were gifts made by you on your death. These provisions can be particularly useful for tax and succession planning, as your trustees can take account of all surrounding circumstances during that two-year period (including the relative financial and personal situations of all potential beneficiaries). Discretionary trusts are subject to two additional types of IHT charge during their existence, at the rate of 6% as follows:
  - **Exit charges:** these charges apply when property leaves the trust. In the first ten years after your death, unless property is subsequently added to the trust, the rate for any exit charges should be 0%.
  - **Ten-year anniversary charges:** these charges apply every ten years after your death. The amount of the charge is broadly based on; the value of assets in the trust on the ten-year anniversary, any assets that leave the trust in the preceding ten years and the settlement nil rate band (which is a separate tax free band that applies to any trusts you set up in your lifetime or in your Will) that is applicable on the anniversary date.

## *Gifts to beneficiaries under 18 years: tax treatment*

If you make a gift to a beneficiary who is under 18, the beneficiary is legally entitled to the income, although your trustees can hold it in a separate account for them. A gift to a beneficiary under the age of 18 may be subject to the following tax charges:

- **Income tax:** the income is taxed as the beneficiary's income, with the benefit of the beneficiary's personal allowance and at the tax rate that applies to them.
- **IHT:** there is no additional IHT to pay unless the beneficiary dies before reaching the specified age. Therefore, there is a potential IHT liability on the combined value of the cash gift and the beneficiary's own personal estate.

## *Trusts for your children at 18 years*

If the child has already reached the age of 18, there is no charge to IHT. However, if a child that dies before the age of 18 had a child of their own (your grandchild), that

grandchild would take the share of the deceased parent. If this happens, the grandchild's share may attract IHT from time to time and when the trust ends.

## *Trusts for your children between 18 and 25 years*

The tax rules for this type of trust are very complicated and you should not hesitate to discuss them further with us if you wish to. In general terms, the trust functions as follows:

- If your children were already over 25 when you die, they would be entitled to the property and so no trusts would arise.
- If your children had not reached the specified age when you die, assuming the value of your estate is not greater than the nil rate amount, it is unlikely that any IHT would be charged on the trusts.
- If the children were to receive their share of the estate no later than the age of 18, no IHT charges would arise.
- If your children were due to take their share later (at any age up to 25), IHT charges may arise once the child turned 18. For example, if a child took their share at age 21 there would be three years' worth of tax to pay (from age 18 to age 21).

Bear in mind that at current levels, the rate of tax is low. In the worst-case scenario, the tax rate when inheriting at age 21 is 1.8%, which is charged on the value of the property that the child takes at 21. In most cases, however, the rate is less than that.

There may be good reasons why you do not wish your children to inherit at 18. However, for maximum flexibility, you may wish to have your Will give your trustees the power to pay out your children's shares early. If your trustees paid the shares out to children aged 18 or under, the IHT charge would be avoided altogether, which could be particularly useful if tax rates were to rise in the future.

You should also consider and bear in mind the following:

- If you wish to delay a child taking their share until an age later than 25, you should discuss this with us, as the IHT treatment is different in these cases.
- Your Will provides that, if a child dies before taking their share and leaves a child (your grandchild), that grandchild takes the share of the deceased parent. If this happens, the grandchild's share may attract IHT from time to time and when the trust ends.

## *Life interest trusts for children or grandchildren*

The assets in the residuary estate are treated for tax purposes as though they belong to the life tenants, in equal shares, through the branches of the family tree.

## *Default gift of the trust fund*

Gifts to named or class beneficiaries attract IHT. If a beneficiary dies before taking their share and leaves a child, that child takes the share of the deceased parent. If this happens, the child's share may attract IHT from time to time and when the trust ends. Gifts to named charities are exempt from IHT.

## Glossary

**Agricultural property relief:** a relief from inheritance tax. When the conditions for the relief are met, it reduces the value of gifts of agricultural property made in a person's lifetime or on death.

**Business property relief:** a relief from inheritance tax for certain shareholdings, interests in a business or assets used by the owner's business. When the conditions for the relief are met, it reduces the value transferred by a gift made during a person's lifetime or on death.

**Estate:** everything that belonged to a person who has died, including all their debts.

**Potentially exempt transfer (PET):** A gift given by an individual more than seven years before their death, which thus becomes exempt from IHT.

**Residuary estate:** the portion of a person's estate that is left after the payment of specific gifts, debts, funeral expenses, and inheritance tax.

**Real property:** all land, property and anything that is firmly attached or integrated, as well as all interests associated with the land.

## How Roche Legal can help

Dealing with legal issues can be confusing and stressful. We understand this, and we're always on hand to untangle jargon and offer support.

If you need advice on any of the issues raised in this help guide, please don't hesitate to [get in touch](#). Roche Legal is an award-winning legal practice, offering practical and caring advice.

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