

Flexible friends

STEPHEN HAGGETT reminds practitioners of the continued importance of using flexible will trusts in estate planning.

It is almost ten years since I first wrote on the potential importance that discretionary will trusts could play in estate planning, despite the tax legislation that introduced the transferable nil rate band (TNRB) for inheritance tax purposes from October 2007. The concept of that legislation is now widely known and simple – the right of married couples (or civil partners) to claim a combined inheritance tax exemption of £650,000 (twice the individual nil rate band exemption of £325,000) on the second death.

The residence nil rate band (RNRB) emerged on 6 April 2017. For clients with homes and direct descendants (children and grandchildren) this introduces a further valuable exemption. For a married couple this should be worth a further £350,000 by 2020. When added to the basic nil rate band this gives such a couple combined inheritance tax exemptions of up to £1m.

Both exemptions are transferable, but very distinct with each able to be used independently of the other. The transferable residence nil rate band is indicated as TRNRB in the examples and computations in this article.

With the phased introduction of the RNRB some advisers have suggested that clients write very simple wills leaving everything to the survivor on the first death with reliance being placed on these transferable exemptions. Others have suggested testamentary gifts to children or other lineal descendants. The discretionary trust concept appears to have been maligned during this process with even some of the quality newspapers developing an almost hysterical cry for these to be dismantled to avoid any tax calamity.

That misconception can be redressed by illustrating the potential benefits of using a flexible discretionary trust on



at least the first death. It is not a comprehensive analysis of tax legislation; instead, the advantages of employing such testamentary arrangements will be illustrated by real case studies, comparing the inheritance tax consequences of using a simple will with one that incorporates a flexible discretionary trust.

Using discretionary trusts

Clients will doubtless be interested in the potential inheritance tax benefits of using discretionary trusts, but many clients will be equally concerned about wealth preservation in the context of their strategic estate and succession planning. Non-tax factors may include protection planning against care fees, divorce, second marriages, incapacity and the like. There is little point in having in place simple wills giving assets outright to family members if that value then becomes exposed to risk. Arguably, suitable trust arrangements provide enormous flexibility in enhancing the prospects for both wealth preservation as well as securing considerable tax savings.

MRS P: 2017 – NO PLANNING

Mrs Powell’s personal estate at death

	£	£
Home (2017)		375,000
Rental property		225,000
Investment portfolio		300,000
Cash		75,000
Total		975,000
<i>Less: inheritance tax exemptions</i>		
Nil rate band (including TNRB)	650,000	
RNRB (including TRNRB) *	200,000	850,000
Net chargeable estate		125,000
Inheritance tax payable at 40%		£50,000

*Note.

Assuming Mrs Powell died after the 6 April 2017

KEY POINTS

- A full discretionary trust provides flexibility and scope to re-writing the will under IHTA 1984, s 144.
- Assets that qualify for business property relief can be recycled.
- Consider preserving all available nil rate bands across several generations.
- Case studies illustrate vital capital tax planning elements.
- The transferable nil rate band is eroded in larger estates.

MRS P: 2020-21 – NO PLANNING

Mrs Powell's personal estate at her death

	£	£
Home (2017 value + 20%)		450,000
Rental property (2017 value + 20%)		270,000
Investment portfolio (2017 value + 25%)		375,000
Cash		<u>75,000</u>
Total		1,170,000
<i>Less: inheritance tax exemptions</i>		
Nil rate band (including TNRB)	650,000	
RNRB (including TRNRB)	<u>350,000</u>	<u>1,000,000</u>
Net taxable estate		<u>170,000</u>
Inheritance tax payable at 40%		<u>£68,000</u>

Note:

This assumes a simple will leaving the whole estate to the surviving spouse on the first death (either absolutely or through life interest trust) with assets then passing absolutely to lineal descendants on the second death.

In the context of estate planning, a will that creates an initial full discretionary trust has one distinct advantage over any other type of testamentary arrangement. The trustees can consider all relevant circumstances after the first death and act in the best interests of the family having regard to the wishes of the testator.

This allows trustees to adapt to events that may evolve long after the will's original execution by taking full advantage of IHTA 1984, s 144 ('Distribution etc from property settled by will'). Trustees of a discretionary will trust can exercise their over-riding powers within two years of death to ensure 'reading back' for all inheritance tax purposes; in effect, re-writing the will. For example, on any death trustees could appoint all funds outright to the surviving spouse or create a qualifying interest in possession. In these circumstances the discretionary trust is ignored.

Assuming the combined estate then passed to direct descendants on the second death, this would enable both the

basic and residence nil rate bands to be claimed fully at that time. Other options are possible.

Alternatively, the trustees could carve out a nil rate band discretionary trust with any residue passing outright or by way of a qualifying interest in possession trust to the surviving spouse. Again, this would preserve all available inheritance tax exemptions. Our first case study of Mrs Powell compares the fiscal consequences of such planning.

Case study – Mrs Powell

Mrs Powell is retired and in her early 80s with two adult children. She has just been widowed and, on her husband's death, their combined assets comprised:

■ The family home	£375,000
■ A rental property	£225,000
■ An investment portfolio	£300,000
■ Various cash savings	£75,000

The present inheritance tax exposure is shown in **Mrs P: 2017 – No Planning**.

Before the introduction of the transferable nil rate band, advisers invariably suggested wills incorporating nil rate band discretionary trusts. What are the tax consequences if those same advisers now merely suggested a simple will in which the whole estate passes outright to Mrs Powell with reliance ultimately placed on all transferable exemptions on her death.

Let us assume that Mrs Powell dies during 2020/21 with both her home and rental properties having increased in value by 20% and the investment portfolio by 25%. In such a case, on Mrs Powell's death her children potentially face an inheritance tax bill as illustrated in **Mrs P: 2020-21 – No Planning**.

Assuming such growth materialised, the potential inheritance tax bill for Mrs Powell's estate will in fact have risen to around £68,000 by 2020-21. This is because by 2020 her estate would fully benefit from the full residence exemption being introduced by the current government. However, from 2020-21 her inheritance tax liability could again escalate because of the more restrictive nature of future increases in tax reliefs.

Although asset values can of course rise as well as fall, various economic forecasts seem quite buoyant about the prospects for both the housing and equity markets, with some predicting increases of between 20% and 40% over the next five years or so. By contrast, the basic nil rate band has been frozen at its current level until at least 2020 and, thereafter, there is a suggestion that future increases may be restricted to around 1% to 2%, assuming the consumer price index remains relatively low. This index is used by the government in fixing future allowances and reliefs.

Rising property prices

The phased introduction of the RNRB may provide some short-term relief, although this may be negated by rising property and equity prices.

This can be illustrated in **Mrs P: 2025-26 – No Planning**. This shows a modest rise in both property and equity prices of

MRS P: 2025-26 – NO PLANNING

Mrs Powell's personal estate at her death

	£	£
Home (2020 value + 15%)		510,000
Rental property (2020 value + 15%)		310,000
Investment portfolio (2020 value + 20%)		450,000
Cash		<u>75,000</u>
Total		1,345,000
<i>Less: inheritance tax exemptions</i>		
Nil rate band (including TNRB) (assumed)	700,000	
RNRB (including TRNRB) (assumed)	<u>370,000</u>	<u>1,070,000</u>
Net taxable estate		<u>275,000</u>
Inheritance tax payable at 40%		<u>£110,000</u>

MRS P – TRUST PLANNING 2020-21

Mrs Powell's personal estate at her death

	£	£
Home (450,000 – 20%, note (i))		365,000
Rental property (270,000 – 20%, note (i))		216,000
Investment portfolio (note (ii))		44,000
Cash		<u>75,000</u>
Total		700,000
<i>Less: inheritance tax exemptions</i>		
Nil rate band	325,000	
RNRB (including TRNRB)	<u>350,000</u>	<u>675,000</u>
Net taxable estate		<u>25,000</u>
Inheritance tax payable at 40%		<u>£10,000</u>

Notes.

- (i) Computation shows 10% co-ownership discount assuming 10% of both properties appropriated into trust.
- (ii) Asset value sheltered within flexible discretionary trust £403,250 (investment portfolio £331,250 plus 10% realty).
- (iii) Nil rate band discretionary trust created in 2017 by:

	£
Home (10%)	37,500
Rental property (10%)	22,500
Investment portfolio	<u>265,000</u>
Total	<u>£ 325,000</u>

between 15% and 20% over this five-year period. However, and despite some increase in allowances, Mrs Powell's potential inheritance tax liability shows a staggering 62% increase.

This is hardly surprising when looking back at the historic returns of both property and equity prices over the past 20 to 30 years. For example, over the past two decades property prices in southern England, together with private investor investment portfolios, have benefited from a rise in capital values of between 280% and 330%. This presupposes that clients have spent all their income. In reality, any accumulation would have enhanced these returns. By contrast, the basic nil rate band has increased by a mere 50%. This has led to an escalating number of estates being sucked into the inheritance tax net.

The latest report from the Office for Budget Responsibility predicts that this trend will continue with a rise of more than 30% in death duty yields by 2021-22.

Mrs Powell's own inheritance tax liability might have been significantly reduced if a flexible discretionary trust had been incorporated in her husband's will. The exact savings will depend on how the trust is constituted and the assets available – ideally, the family would look to shelter those assets that show the greatest prospects for future growth.

It would also be possible to secure a co-ownership discount even if only a small percentage of both the house and rental properties were held within the trust. This has the potential to substantially reduce the value of both properties for inheritance purposes.

Mrs P's Trust Planning 2020-21 shows the reduced inheritance tax bill of £10,000, a saving of £58,000 compared

to the previous calculations shown for 2020-21 which relied on very simple wills. This assumes her husband's will had incorporated trust planning.

Contrary to some reporting, these arrangements can be implemented by carefully selected trustees. A correctly drafted will and re-structure within s 144 will avoid the need for beneficiaries to consent. Nor will it put the family in a position where reliance may have to be placed on a deed of variation, which may prove impractical or costly for many reasons. Although s 144 provides a two-year period, in practice trustees may exercise their overriding powers before the application for the grant.

Subject to this nil rate band trust, Mr Powell's surviving widow could have received any balance outright or an immediate post-death interest created in her favour. Either way, this would have fully preserved the benefit of the transferable residence nil rate band while carving out a discretionary trust to shelter investment growth.

For Mrs Powell's family the inheritance tax saving secured by the discretionary trust should continue to grow over time.

The Hampshire family

For wealthier clients holding assets qualifying for favourable tax reliefs the potential inheritance tax savings can be substantial. Such clients also risk exceeding the taper threshold thereby denying any of the residence nil rate band.

The taper threshold of £2m reduces the RNRB if the value of the deceased's estate at death exceeds this.

For taper purposes, the deceased's 'estate' has its normal inheritance tax meaning: assets less deductible liabilities. However, exemptions and reliefs such as the spousal exemption or business property relief are not deducted when calculating the value of the estate and this may lead to all RNRB being lost.

Many wealthy clients may have investments that benefit from business property relief and may typically include Alternative Investment Market (AIM) investment portfolios or other assets that seek to secure such relief. Business property relief delivers full relief from inheritance tax after just two years' ownership and has become a valuable option for many clients as part of their retirement planning.

The benefit of these arrangements can be illustrated in the case study of the Hampshires – a retired couple with two children. Again, let us assume that Mrs Hampshire dies during 2020-21, having survived her husband's death by four years. On Mr Hampshire's earlier death, their combined asset wealth was £3m and included his AIM portfolio of £750,000, which qualifies for business property relief. Mrs Hampshire had also inherited her parents' estates totalling £150,000 some 25 years earlier, which had been fully invested and forms part of the general investment portfolio.

If, on Mr Hampshire's death, his assets had simply passed to his widow then, on Mrs Hampshire's subsequent death, her estate and the resultant inheritance tax liability (ignoring any future growth) can be shown in *Mrs H BPR: 2020/21 – No Planning*.

The same result would arise if Mrs Hampshire was given a qualifying interest in possession. Both scenarios prevent any use of the residence nil rate band as a result of taper. But would a flexible discretionary will prove preferable?

MRS H: BPR RECYCLING – 2020-21

Assuming that business property relief (BPR) was recycled, Mrs Hampshire's personal estate at her death and the resultant inheritance tax liability would be calculated as follows:-

	£	£
Home		750,000
AIM portfolio (assuming two years' ownership)		750,000
Investment portfolio		175,000
Cash		<u>250,000</u>
Total		1,925,000
<i>Less: inheritance tax exemptions</i>		
Nil rate band	325,000	
RNRB (including TRNRB)	350,000	
Business property relief	<u>750,000</u>	<u>1,425,000</u>
Net taxable estate		<u>500,000</u>
Inheritance tax payable at 40%		<u>£200,000</u>

Notes.

- (i) Asset value sheltered within flexible discretionary trust £1.075m.
- (ii) Inheritance tax saving £440,000.

It would then be possible for the business property relief to be recycled. This would involve the trustees of the discretionary trust disposing of their qualifying assets to Mrs Hampshire. In return, assets that would otherwise be chargeable on her death would enter the discretionary trust in satisfaction of those assets she acquired. Assuming such assets were held by Mrs Hampshire at her death, her estate's revised inheritance tax liability is shown in *Mrs H: BPR Recycling – 2020-21*.

This structure results in an inheritance tax saving of £440,000. Such planning can help to preserve the benefit of the transferable residence nil rate band without any loss of taper. Subject to the overriding discretion of the trustees, the surviving widow can still enjoy the combined estate while protecting the underlying capital from longer-term inheritance tax liabilities and potential asset protection issues. Further, there is also nothing preventing her being one of the trustees.

Alternatively, some advisers recommend a gift of the business property relief qualifying assets directly to the children on the first death. Such action may not prevent some taper to the RNRB.

In fact, had such a gift been made, Mrs Hampshire's executors would still be facing an inheritance tax bill of £550,000.

For the Hampshires there is a final sting in the tail. As indicated, Mrs Hampshire had inherited £150,000 from her late parents some 25 years earlier, which was now fully reflected in the general investment portfolio. However, its value had grown by some 300% over that period and at Mrs Hampshire's death represented some £600,000 of the portfolio value. Estate planning invariably requires a holistic and structural approach potentially across several generations.

Had her parents preserved their nil rate bands in the form of discretionary trusts, this asset value would also now be sheltered from any inheritance tax liability. For the Hampshires this would have eliminated any death duties, taking into account the recycling option.

Trust planning

The trustees, when exercising their overriding powers under s 144 after Mr Hampshire's death, could direct the business property relief assets into a discretionary trust. Further, other assets to the value of Mr Hampshire's inheritance tax nil-rate band exemption could be added to the trust.

This means that, instead of everything passing outright to Mrs Hampshire, assets totalling £1.075m (£750,000 business property relief plus £325,000 nil rate band) initially enter the discretionary trust. The remaining estate can be given to Mrs Hampshire in the form of a qualifying interest in possession trust or outright.

MRS H: BPR ASSETS 2020-21 – NO PLANNING

Assuming simple wills, Mrs Hampshire's assumed estate at death and resulting inheritance tax liability is calculated as follows:

	£	£
Home		750,000
AIM portfolio (BPR)		750,000
Investment portfolio		1,250,000
Cash		<u>250,000</u>
Total		3,000,000
<i>Less: inheritance tax exemptions</i>		
Nil rate band (including TNRB)	650,000	
Business property relief	<u>750,000</u>	<u>1,400,000</u>
Net taxable estate		<u>1,600,000</u>
Inheritance tax payable at 40%		<u>£640,000</u>

Conclusion

The concept of both the above transferable inheritance tax exemptions has resulted in many clients, but perhaps more alarmingly numerous advisers, assuming that discretionary trusts should be readily dismantled.

Arguably, trust arrangements that provide enormous flexibility and the scope for a family's wealth to be protected and preserved across multiple generations should not be lightly dismissed. Advisers who ignore this planning possibility may face tougher and potentially embarrassing questions in future.

Despite the traps for the unwary, the advantages of preserving all available nil rate bands as part of a family's longer-term holistic planning can yield enormous tax benefits. ■

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