



## **NIL RATE BAND DISCRETIONARY TRUSTS – AN EXPLANATION**

Inheritance Tax and Inheritance Tax mitigation measures are both subjects of great complexity. Please note what follows is a summarised explanation of how the provisions of a Nil Rate Band Discretionary Trust operates on the death of a spouse where similar Wills have been executed by each spouse.

### **FUNCTION OF THE TRUST**

The Trust is designed to operate only on the death of the first spouse. If the first spouse were to leave everything to the survivor this would result in no Inheritance Tax being payable on first death. However, it would increase the estate of the surviving spouse thereby leading to a bigger potential Inheritance Tax liability on the death of the surviving spouse.

It is possible to leave a certain amount of your estate (known as the Nil Rate Band) to beneficiaries other than the surviving spouse, without creating an Inheritance Tax liability on first death. Currently, Inheritance Tax is payable at 40% on the value of a person's estate in excess of the Nil Rate Band which is currently £300,000 and is due to increase further in April 2008. If however use is made of the Nil Rate Band entitlement on first death (i.e. the £300,000 threshold at which Inheritance Tax starts to bite) a potential tax saving of up to £120,000 may be achieved.

The Nil Rate Band could of course be left to your children outright. This however runs a risk that the surviving spouse may not be adequately provided for financially and would probably require the financial security of the income from the capital if not the capital itself. Furthermore, it may not be desirable for children to benefit from such a large legacy. A potential solution to this problem lies in the creation of a Discretionary Trust under a Will. The reason why this works is that the surviving spouse is capable of benefiting from the Discretionary Trust but the Trust is not liable to Inheritance Tax on the first or second death under current tax law, subject to any increase in value of the Trust Fund which may be liable to tax.

By creating a Discretionary Trust under a Will and including the spouse as one of the beneficiaries, such sum is kept separate from the survivor's estate but is still available for the survivor if the need arises. Such trusts are often referred to as "Nil Rate Band Discretionary Trusts".

A Nil Rate Band Discretionary Trust is designed to take maximum advantage of the Inheritance Tax breaks currently available whilst at the same time ensuring that the funds are available for the survivor if required.

## **BENEFICIARIES**

A Discretionary Trust is just that; discretionary. No beneficiary has a “fixed entitlement” and in the interests of flexibility, the class of beneficiary ought be very wide. Beneficiaries would normally include:-

- The surviving spouse
- Children and remoter issue (i.e. grandchildren and so on)
- The spouse’s widow or widowers or children and remoter issue

There maybe other members of the family that may be included as potential beneficiaries as well as charities.

## **THE “NIL RATE BAND”**

The amount going into the Trust is equal to the unused part of the Nil Rate Band after taking into account any lifetime gifts that might have been made and any legacies that may be contained in the Will.

Provided that both husband and wife have sufficient assets to create a Trust of the type described (the share of the matrimonial home can be used for this purpose – although this needs care) both Wills should include the appropriate provisions, although it is only on the first death that such a Trust comes into existence.

## **DISTRIBUTION BY TRUSTEES**

Distribution of capital and income from the Trust to such beneficiaries is entirely at the discretion of the Trustees.

For the first 21 years of the life of the Trust, the Trustees have no obligation to distribute income to the beneficiaries and subject to certain restrictions any income not distributed can be retained in the Trust.

As the discretion given to the Trustees is wide, the choice of suitable people as Trustees is very important. It is usual (although not compulsory) to appoint a surviving spouse as one of the Trustees along with either an independent professional Trustee or another family member.

## **DURATION OF THE TRUST**

In theory, the Trust could continue for a period 80 years but in practice the Trust will be brought to an end much sooner in accordance with the Letter of Wishes that is usually placed with the Will.

## LETTER OF WISHES

It is useful to leave something in writing so as to indicate to the Trustees the intention as to how they should exercise their powers over the Nil Rate Band Trust. Such a letter would normally indicate that on the first death the surviving spouse ought to be regarded as a main beneficiary of the Nil Rate Band Trust and that the remaining funds should be held for any children.

Another option is for the Trust Fund to be lent to the surviving spouse so that he/she has full use of the funds without restriction. This would be a debt of his/her estate on death.

## FUNDING AND NIL RATE BAND

It is essential that each spouse holds sufficient assets in their name to fund the Trust. It may be that they already have sufficient cash or investments in each of their names or they may need to rearrange how some of their assets are held. This is often the case where the family home is the most valuable asset. This is explained further below.

## YOUR PROPERTY

Property may be held either jointly either as (1) joint tenants or (2) tenants in common. Under a joint tenancy, one half of the property will automatically pass to the surviving owner after the first death. This is the usual manner by which property is jointly held.

To enable half of the property to fall into the estate and thus be available to fund the Discretionary Trust it is possible to sever the joint tenancy by serving an appropriate notice on the other joint tenant and making an application to the Land Registry. We can undertake this on your behalf.

Please be aware that this is a summarised explanation of Nil Rate Band Discretionary Trusts based upon the law as at May 2007 and is subject to change. For specific advice in relation to your individual circumstances please contact either Mr D. Bonn ([dominique.bonn@whiskers.co.uk](mailto:dominique.bonn@whiskers.co.uk)) or Mr J. Schoop ([jonathan.schoop@whiskers.co.uk](mailto:jonathan.schoop@whiskers.co.uk)) in our Private Client Department.