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Drafting & Consultancy

A GUIDE TO EVERYTHING YOU NEED TO KNOW ABOUT INHERITANCE TAX

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Don't leave it too late, delaying what needs to be done can be costly in many, many ways.

Regards
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Inheritance tax: thresholds, rates and who pays

In England and Wales, Inheritance tax ("IHT") of 40% is paid on what you leave to beneficiaries. There are, however, thresholds of IHT free amounts and also allowances of what you can leave certain classes of people. There are also tax planning strategies that can be set up to minimise the IHT that is payable from your estate or those benefitting from your estate after your death.

What is IHT?

Upon your death, if you plan to pass on assets or money, your heirs could face a tax bill of up to 40%. Your estate is defined as your property, savings and other assets after debts and funeral expenses have been deducted. You can reduce or avoid IHT in several ways. There's a tax-free allowance, and you can also give away a certain amount of your money whilst alive, tax-free and without it counting towards your estate.

IHT thresholds and rates 2020-21

Everyone in the 2020-21 tax year has a tax-free inheritance tax allowance of £325,000 – known as the nil-rate band (the "NRB"). The NRB allowance has remained the same since 2010-11 and as such the standard inheritance tax rate is 40% of anything in your estate over the £325,000 threshold. For example, if you leave behind an estate worth £600,000, the tax bill will be £110,000 (40% on £275,000 – the difference between £600,000 and £325,000). However, if you're married or in a civil partnership, you may be able to leave more than this before paying IHT. As of April 2017, you can also pay less IHT if you're leaving property to a family member. For the 2020-21 tax year, this new transferable allowance rose to £175,000, up from £150,000 in 2019-20.

Do spouses pay IHT?

Married couples and civil partners can pass their possessions and assets to each other tax-free in most cases. The surviving partner can use both tax-free allowances, providing the first spouse to die did not use up their full inheritance tax allowance by giving away a big chunk of money in their Will. In 2020-21, most married couple or civil partners can pass on up to £650,000, or £1m if your estate includes your home, effectively doubling the amount the surviving partner can leave behind tax-free without the need for special tax planning. However, some people whose partner died before 21 March 1972 will be caught by a loophole which means they don't get a 'double allowance'.

Gifts and other ways to avoid IHT

Some gifts are usually tax-free. These include gifts between spouses and civil partners, and gifts to charities. Other gifts are potentially tax-free (known as potentially exempt transfers or PETs) depending on when they were made. Generally, if a gift is made more than seven years before your death to an individual – not to a business or a trust – you won't pay tax on it.

If you do die within these seven years, the tax payable on the gift may be reduced, depending on when the gift was made. There are other ways to avoid inheritance tax, too - including putting your life insurance policy under trust or having a deed of variation in your Will.

Trusts can also be a useful way to manage your IHT bill and keep an element of control over what happens to your assets when you pass away. There are also other options like equity release and insurance policies

Who pays the IHT bill?

Inheritance tax due on money or possessions passed on when you die is usually paid from your estate. Your estate is made up of everything you own, minus debts, such as your mortgage, and expenses such as funeral expenses. Your heirs must pay IHT by the end of the sixth month after the person died. An inheritance tax reference number from HMRC is needed first and should be applied for at least three weeks before a payment needs to be made. However, if the tax is due on gifts you made during the last seven years before your death, the people who received the gifts must pay the tax in most circumstances. If they can't or will not pay, the amount due then comes out of your estate.

Inheritance tax for married couples and civil partners

Married couples and civil partners can make use of each other's tax-free allowance without special tax planning.

What are the inheritance tax rules for married couples?

There are major benefits to being married or in a civil partnership when it comes to inheritance tax. Transfers between married couples and civil partners are not usually subject to inheritance tax (IHT), so if the first partner to die leaves their entire estate to the other, no tax will be payable. It's also likely that none of their nil-rate band has been used, and the partner will be able to add the unused balance to their own, effectively doubling the threshold. However, if your partner has left bequests to others (and lifetime gifts made within seven years of death), their estate may attract IHT if it's large enough and may use up some or all of the nil-rate band.

Applying the nil-rate band

Couples are usually able to inherit tax-free from their married spouse or civil partner. They can also apply any of their partner's unused nil-rate band - the amount you can leave tax-free - to their own estate. For example, say your partner left £162,500 from their estate to people other than you. Given the tax-free allowance is £325,000, you can claim only 50% of the tax-free allowance. If the tax free allowance when you die is £400,000, you would have this full amount, plus the percentage of your partner's unused allowance – which would be 50% of £400,000 or £200,000. This gives you a total tax-free allowance on your death of £600,000. This applies even if your partner has already died, provided they died after 12 November 1974.

Inheritance tax on property for married couples

On top of the main allowance, the transferable main residence allowance that came into effect in April 2017 means people can leave significantly more, if the estate includes a property being left to direct descendants (children, grandchildren and stepchildren, but not nieces or nephews). As of April 2020, it increased to £175,000 from £150,000 for 2019-20. This effectively raises the IHT-free allowance to £500,000 for most people. Where married couples jointly own a family home and want to leave it to their children, the total IHT exemption will be £1m. If this allowance is transferred between spouses, the value of the transferred allowance will depend on when the second, not first, partner dies.

Using a Will for inheritance tax planning

Before the current inheritance tax rules came in, it was common to use your Will to make sure your tax-free allowance was not wasted. Within your Will, you could arrange for assets or money up to the value of the tax-free allowance to be passed to someone other than your husband, wife or civil partner on the first death, or to be passed to a trust set up in your Will from which your spouse could benefit. However, these arrangements are no longer necessary for most people and may even be disadvantageous if they involve a discretionary trust. Furthermore, by using the tax-free allowance at the first death, you will lose out on any increase to the tax-free allowance that may occur between the death of the first partner and the death of the second partner. The £175,000 transferable main-residence allowance is only available when leaving property directly to a child or grandchild, or into an Immediate Post Death Interest trust. As an alternative, you may be better off using your spouse's tax-free allowance to increase your own nil-rate band. If you have already set up your Wills this way, it may be worth going back to the firm that arranged this for you and ask their advice on how you should proceed considering the new inheritance tax rules.

Restrictions on transfers for married couples

Inheritance tax was introduced in 1986, replacing capital transfer tax – which originally replaced estate duty. The degree to which transfers between spouses were tax-exempt differed from today, meaning the estate of a surviving partner will be taxed differently, depending on the date their partner died. In cases of doubt, it may be worth checking the exemption allowable with a tax consultant.

<u>If your partner died after 12 November 1974</u>

After 12 November 1974, there was no limit to spouse exemption, unless the deceased had their home in the UK and the surviving spouse did not – when it was limited to £55,000. After 6 April 2013, the exemption is the inheritance tax nil-rate band.

If your partner died between 22 March 1972 and 12 November 1974

During this period spouse exemption was limited to £15,000, so the amount of unused allowance you can claim is severely limited.

If your partner died before 22 March 1972

If your husband or wife died before 22 March 1972, estate duty, rather than inheritance tax was in force. Under estate duty rules up to that date, no transfers could be made tax-free between husband and wife.

Estates valued at less than a certain amount (this differed depending on date of death) didn't attract tax, but estates over this amount had to pay tax on the whole value. For those living in England, Scotland or Wales, we've given the various rates below which no estate duty was charged in the tables below:

Estate duty limits until 1974

Estate duty Limits: England, Scotland and Wales

Date of death	Amount below which estate duty wasn't payable
On or before 28 August 1946	£100
Between: 29 August 1946 and 29 July 1954	£2,000
Between: 30 July 1954 and 9 April 1962	£3,000
Between: 10 April 1962 and 3 April 1963	£4,000
Between: 4 April 1963 and 15 April 1969	£5,000
Between: 16 April 1969 and 30 March 1971	£10,000
Between: 31 March 1971 and 21 March 1972	£12,500
Between: 22 March 1972 and 12 November 1974	£15,000

Only one tax-free allowance can be used

Because of the way estate duty worked, people who paid estate duty on their late partner's estate are treated as having used up any tax-free allowance due. This is even though tax was paid on the estate and in reality, no tax-free amount was passed on. Under the current rules, when people in this position die, their estate is only entitled to one tax-free allowance. The fact that you can't use their deceased partner's tax-free allowance could mean a much bigger inheritance tax bill for your heirs.

Can spouses inherit Isa's tax-free?

Any money held in an Isa forms part of your estate when you pass away, although your surviving spouse can still benefit from the extra tax protections these accounts offer. Since 3 December 2014, bereaved spouses and civil partners have been allowed to re-invest cash and investments held in their partner's Isa, allowing them to take interest dividends and growth tax-free. The allowance is called an Additional Permitted Subscription (APS). Be aware that not all Isa providers let people use it, so you'll need to check with your provider that they accept these extra deposits before transferring. If not, you're free to open another one that does, even if you've used part of your Isa subscription in the current tax year.

Inheritance tax on property

Everything you need to know about how your property is taxed when you pass it on to your heirs, and the rules and thresholds for the main residence nil-rate band in 2020-21.

Do I pay inheritance tax on my home?

As with the vast majority of assets, inheritance tax is levied on property when you pass away. But thanks to an extra allowance introduced in April 2017, couples could now leave property worth up to £1m before paying any tax, if they pass away from the 2020-21 tax year onwards. The tax-free amount depends on who you leave the property to, when you pass away and the overall value of your estate.

What is the main residence nil-rate band?

The main residence nil-rate band is an extra property allowance that allows people to leave their homes to family tax-free. Under the rules, if you're passing your home to a direct descendant, you can benefit from an additional £175,000 in tax-free allowance in the 2020-21 tax year, up from the £150,000 allowance in 2019-20. The allowance only applies if you leave your home to a direct descendant – either a child or grandchild. Nieces and nephews, or friends, for example do not qualify. Not everyone will qualify for the full allowance. If your total estate is worth more than £2m, the extra allowance tapers off, falling by £1 for each £2 above the threshold.

Married spouses and civil partners may be able to apply the unused allowance of their deceased partner – meaning they could pass on property worth up to £350,000 tax-free in 2020-21.

Inheritance tax property rates

The increase to the main residence nil-rate band happened gradually between April 2017 and April 2020.

The table below shows how the inheritance tax allowance increased over the past few years.

Inheritance tax property thresholds

Tax year	Nil-rate band (NRB)	Residence NRB	Total for individuals	Total for couples
2017-18	£325,000	£100,000	£425,000	£850,000
2018-19	£325,000	£125,000	£450,000	£900,000
2019-20	£325,000	£150,000	£475,000	£950,000
2020-21	£325,000	£175,000	£500,000	£1,000,000

From April 2020, you'll be able to pass on £175,000. Your spouse or civil partner has the same allowance, effectively doubling what you can pass on to £350,000. The property allowance will be layered on top of your inheritance tax allowance, which has been set at £325,000 since 2010.

This means that in 2020-21 you can pass on as much as £500,000 tax-free as an individual, or £1m as a couple. After 2020, the plan is for the main residence nil-rate band to increase annually with inflation.

Who can inherit my property tax-free?

The government's rules state that only 'direct descendants' of people who have died can benefit from the new main residence nil-rate band.

Direct descendants are described as:

- Children and their spouses or civil partners
- Grandchildren and their spouses or civil partners
- Great-grandchildren and their spouses or civil partners
- Stepchildren
- Adopted children
- Foster children
- Children who were under the guardianship of the people passing on their estate.

This means that nephews, nieces, siblings and other relatives will not benefit from the new allowance if a home is passed on to them.

Which properties qualify for the nil-rate band?

The main residence nil-rate band applies to only one home. It must be included in your estate (i.e. counted within the assets you owned directly, not via a trust) and you need to have lived in it at some stage in your life. If you own more than one home, the executor of your estate can nominate which one should be used against the inheritance tax property allowance. The good news is that you don't have to have lived in or owned the property for a minimum time – it can be any property you've lived in at some point. The home doesn't even have to be in the UK, but whether your heirs pay UK inheritance tax depends on your 'domicile' at the time of your death.

Estates worth more than £2m

If you have a larger estate, the main residence nil-rate band, and therefore the amount you can pass on tax-free, reduces gradually, known as 'tapering'. For every £2 that your estate is over £2m, the new property allowance is reduced by £1. So, if your estate is worth £2.4m in the 2020-21 tax year, you'll lose the entire main residence nil-rate band.

The table below shows the size of estate when the entire nil-rate band is lost. How the inheritance tax allowance is reduced for estates worth more than £2m

Tax year	Main residence NRB	Size of estate when all NRB is lost
2017-18	£100,000	£2.2m
2018-19	£125,000	£2.25m
2019-20	£150,000	£2.3m
2020-21	£175,000	£2.4m

Can you give away your property tax-free?

It's crucial that any gift is a genuine gift. If, for example, if you give away your home but continue to live in it rent-free until your death, you'll be deemed to be the beneficial owner, and it will still be taxed as part of your estate when you pass away. The same gifting rules apply to property as other assets. If you give away a home within your lifetime, it will be classed as a potentially exempt transfer, meaning inheritance tax may be charged if you die within seven years of making the gift.

If the gifts are worth less than the £325,000 allowance, they'll be added to your estate to work out your taxable estate. If they're worth more, then they will use up your tax-free allowance, and you'll be charged a tapered rate on the excess, which depends on how long you live after making the gift.

Inheritance tax rates on gifts above the £325,000 allowance

Time between date of gift and date of donor's death	Effective rate charged on gift
0-3 years	40%
3-4 years	32%
4-5 years	24%
5-6 years	16%
6-7 years	8%
More than 7 years	0%

If you live for at least seven years after making the gift then no tax will be due – and your £325,000 tax-free allowance will not be affected. If there is a tax bill, the new owner will be liable to pay it.

Why did the rules change?

The tax-free threshold has stood at £325,000 for many years, but rising property prices have meant more and more people have been pulled into inheritance tax in recent years, with more than £5bn paid at the last take. To reduce this burden, the new property allowance was introduced to help people leave property to family without being hit with large tax bills. Crucially, you only qualify for this new allowance if your estate includes a property that you've used as a home at some point in your life.

How to avoid inheritance tax

There are several ways of helping your heirs avoid having to pay inheritance tax altogether.

Can you avoid inheritance tax?

If your estate is sufficiently large, inheritance tax may be payable after you pass away. But there are ways you can cut your estate's tax bill and increase the amount passed on to your heirs. Below, we outline some options for minimising your inheritance tax.

Make gifts

One of the simplest things you can do to avoid paying inheritance tax (IHT) is to spend or give your money away during your lifetime. You're allowed to spend your money how you want (obviously), so we'll assume you're on top of that. Each tax year, you're allowed to give up to £3,000 away as a gift, split between however many people you like. You're also allowed to make unlimited gifts of up to £250 to others, too. If you're off to a wedding, you can give up to £1,000 and never have to worry about inheritance tax. You can give up to £2,500 to grandchildren, and £5,000 to your children too. Wedding gifts must be made before the wedding, and the wedding must go ahead, otherwise they'll be classed as potentially exempt transfers. If you make gifts above the thresholds, they may be taxable if you don't survive for seven years after making them. Otherwise they'll be tax-free too.

Leave money to a charity

Any money you leave to a charity, providing it is registered in the UK, will always be free from inheritance tax. The same goes to gifts to political parties, or to local sports clubs. What's more, if you leave more than 10% of your taxable estate to one of these groups in your Will, the inheritance tax rate for the rest of your estate will fall from 40% to 36%. The 10% only applies to the amount of your estate over the lifetime allowance. So, for example, if you were leaving behind £425,000, you would benefit from the lower rate if you gave more than £10,000 (10% of the amount over £325,000).

Leave your estate to your spouse

Your spouse or civil partner will never have to pay tax on assets you leave them, regardless of the amount. Making the most of this in your Will can save your family a small fortune. When your spouse passes away, they'll inherit your unused personal allowance, allowing them to pass on up to £325,000 more as part of the main IHT allowance. If they (or you) have remarried, then unused personal allowances can be added together and passed on - but only up to the value of one whole personal allowance (i.e. the most it can increase by is £325,000).

Use property allowances

If you're leaving your estate to children or grandchildren, the new property allowances let you leave more of your home before tax is due. In the current 2020-21 tax year, it's worth £175,000 per person, up from £150,000 in 2019-20. For a married couple, this increases the tax-free amount by £350,000, so including the personal allowance, estates of up to £1,000,000 could be completely free of IHT this year.

Consider equity release

If all your wealth is tied up in your property, you may not be able to make use of gifts during your lifetime or spend your wealth on yourself. To get around this, some people take out an equity release scheme. It's important to remember that all this really does is reduce the assets you own and increase the debts that will count against your estate. If you don't need to access cash from your property, giving assets away earlier is likely to be better for you.

How equity release schemes work

With these schemes, you can either borrow money against the value of your home (known as a lifetime mortgage) or sell part of your home at a reduced market rate but remain living there throughout your life (a home reversion scheme). The money you release can be passed on to your heirs or spent yourself. Providing you survive the gift by seven years, there will be no tax to pay.

When you die

When you die, the value of your estate will be reduced, either by the mortgage debt (with a lifetime mortgage) or because only part of the value of your home will still belong to your estate (with a home reversion).

Think carefully

It sounds simple enough but think carefully before going down this route. With lifetime mortgages, interest is 'rolled up' and your debt can swiftly grow. For example, a £50,000 mortgage with an interest rate of 7% a year will have almost doubled to £98,358 within 10 years. You could end up owing more to your lender than your estate would have paid in tax – either way, your heirs won't benefit. With the other route, you're selling off part of your home for less than its full value. So, think about whether you're willing to let the bank take half of your home, just to stop HMRC getting a slice.

Consult a specialist

If you do think equity release might be for you, we recommend you always consult an independent financial adviser who specialises in equity release before going ahead.

Take out a life insurance policy

If you can't beat an IHT bill, you can insure against it. This is one of the simplest ways of covering an unwelcome bill, but unless you're relatively young and healthy, the cost may be high. Providing the policy is written into trust, the payout won't form part of your estate. You can find out more in our guide to trusts and inheritance tax. HMRC treats the premiums paid to the insurance policy as a lifetime gift if you pay them yourself, but these can usually be covered by one of the tax-free exemptions – either the annual £3,000 exemption or the 'gifts out of normal income' exemption.

Consider a 'deed of variation'?

A deed of variation allows your heirs to alter your Will after death so that, for example, part of the inheritance is re-directed to someone else. They can draw up a deed of variation within two years of your death, but all affected beneficiaries under the Will must agree to the variation. This can be difficult in practice, especially if there are many beneficiaries. As a general rule, it's better to review your Will periodically so that your affairs are tax-efficient. This will simplify the probate process for your executor, and reduce the chances of your loved one's squabbling, which sadly, can happen a lot.

Inheritance tax and trusts

Trusts can help you keep control of what happens to your assets after you pass away. They can be useful from an inheritance tax perspective, though you may end up paying more.

Using trusts to avoid inheritance tax

Trusts are an often overlooked way to manage your estate when you pass away, keeping an element of control over what happens to your assets and how they can be used. The tax treatment of trusts can also mean they're useful for reducing the amount of inheritance tax that will be paid. However, the rules around inheritance tax and trusts are complicated, and it may cost you more. As such, you should think carefully before setting up a trust to avoid inheritance tax and seek appropriate advice. They can be expensive, and tax shouldn't be the main reason for setting one up.

How do trusts work?

As the creator, or 'settlor', of the trust, you stipulate how it ought to be run. After you pass away, the ownership and control will shift to your nominated trustees, who are legally obliged to manage the assets on behalf of your beneficiaries. You'll agree a trust deed, which dictates how the trustees should do that. You must have confidence in the trustees, as they'll legally own the assets. Note that settlors can be trustees too. Assets in trust don't form part of your estate, meaning they won't be included when working out how much inheritance tax is due, providing you live for seven years after placing them into trust. They come in many forms, and there can be variations in the rules, depending on the type of trust it is.

How are trusts taxed?

It's a common misconception that assets in trust are exempt from inheritance tax. You'll normally pay it at 20% when setting up a trust if it's in excess of the nil-rate band. There are some exceptions, such as if you continue to benefit from the assets. The way a trust is taxed depends on what sort of trust it is. For a discretionary trust (the most commonly used for inheritance tax planning), the rules are as follows:

<u>Tax on assets in trust</u>

How much inheritance tax is payable when you put assets in a trust?

1. Pay 20% IHT when setting the trust up

Start by working out the value of the asset that's not covered by your personal allowance. You'll pay a 20% tax charge on this amount when the trust is set up.

2. Pay 6% IHT each 10 year anniversary

Any assets in the trust need to be re-valued each decade. After that, a 6% charge is levied on the value of the total assets, less the £325,000 IHT allowance.

3. Up to 6% tax on exit

Finally, IHT will need to be paid again when the trust is closed, or if assets are removed. Tax is based on the most recent 10-year anniversary valuation, up to 6%, charged on a pro-rata basis.

How do the tax charges work?

The 20% charge applies to the value of assets you put in the trust, less any inheritance tax allowance you haven't used in the last seven years. So, if you placed assets worth £400,000 into trust and hadn't used your allowance elsewhere, you would pay £15,000 (20% of the £75,000 in excess of the £325,000 allowance).

If you set up multiple trusts, this will be factored in when you pay tax establishing the trust. So, if the second trust is established within seven years of the first, you can't claim the £325,000 allowance - only any amount you hadn't already used.

On top of the tax paid when setting up the trust, there's also a tax charge on assets in trust every 10 years afterwards. This is levied on the current value of the assets, after deducting the £325,000 inheritance tax allowance. So, if that £400,000 investment increased in value to £500,000, IHT would be due on £175,000. This is charged at 6% (over the £325,000), so in this example there would be a £10,500 bill.

Finally, an exit charge is levied if or when assets are removed from the trust, or the trust is closed. The tax is charged at the most recent 10-year valuation. Again, the £325,000 IHT allowance is deducted, so if the estate is worth £500,000, then £175,000 would be subject to IHT. The same 6% applies, though it is charged on a pro-rata basis, since the last 10-year charge. So, if five years have passed, you'll pay 3%, and if only one year has passed then 0.6% is charged.

<u>Example: tax on discretionary trusts</u>

Say Carla is transferring her £500,000 property into a trust.

She hasn't used any of her £325,000 personal allowance in the last seven years. So, £175,000 of her property's value is subject to 20% tax on setting up the trust, resulting in a £35,000 bill in the first year.

The assets are re-valued every decade. The property value increases to £750,000 in the first ten years - this is subject to a 6% tax, less than £325,000 allowance. So, the tax bill would be 6% of £575,000, for a total of £34,500 after 10 years.

Five years later, the trust is closed. In that time, the property value has risen to £800,000 - minus the allowance, it comes to £475,000. It's only been five years, so the 10-year tax rate of 6% is halved to 3%. This means 3% tax is payable on £475,000, for a total of £14,250 as an exit charge.

What sort of trusts can be set up?

There are many options available to people setting up trusts, and this list is not comprehensive. This list covers trusts you set up before passing away, though other arrangements exist to establish trusts in your Will.

Bare trusts

Bare trusts are simple trusts used to hold assets on another person's behalf until they choose to take ownership. For example, bare trusts are used to hold assets for a child to ensure they don't use them until they're grown up. These types of trusts don't follow these inheritance tax rules. Instead, assets placed in a bare trust are treated as potentially exempt transfers. You'll pay no IHT when establishing the trust, but if you die within seven years of creating it, it will be taxed as part of your estate.

Discretionary gift trusts

The most popular type of trust. You hand over the assets to the trust and stipulate how you would like them to be used for the beneficiaries. Crucially, the trustees are free to act at their own discretion. The new property IHT allowance can't be claimed against property in a discretionary trust, so if you're already set up one you should review your arrangements with an adviser.

Loan trusts

Available 'over the counter', these can be used to limit future gains in the value of your estate. You lend your assets to the trust, meaning they still form part of your estate. However, any investment returns from your assets remain in the trust and fall outside your estate for tax purposes. Discounted gift trusts These are typically used to hold insurance bonds and allow you to receive income for up to 5% of the bond each year. The capital sits outside your estate and transfers to the beneficiaries when you die.

What will a trust cost?

It really depends on your circumstances. In addition to the inheritance tax charge when setting up the trust, the trustees will likely charge a fee to manage the trust, and there are other legal costs to setting one up. Due to these expenses, you should carefully weigh up whether your estate would benefit from a trust.

Will trusts and lifetime trusts

Find out about what Will trusts and lifetime trusts are, and whether one might be right for you.

What is a Will trust?

A Will trust - also known as a testamentary trust - is created within your Will to allow you to protect property you hope to pass on to your family. Trusts are legal entities that allow someone to benefit from an asset without being the legal owner. You create the trust and appoint a person to manage it - the 'trustee'. The trustee manages the trust on behalf of the 'beneficiaries' - those who receive the income of the trust. Establishing trusts can give you an element of control over assets you wouldn't have if you gave them away outright. There can also be tax advantages, but that should never be the main reason for setting one up. In some cases, you could end up paying more tax by putting assets into trust. Trusts can be complicated structures with tax implications, and you should always seek legal advice before setting one up. There are two main types of trust that you might choose to set up: a Will trust, created upon your death, or a lifetime trust, which you establish during your lifetime. We explain the pros and cons of both.

Leaving property in a Will trust

Unlike a lifetime trust, a Will trust is only created once you pass away. You set up the conditions of the trust in your Will and it activates upon your death. Will trusts are mainly used by couples to split ownership of the family home if they own it as 'tenants in common'. Rather than leaving their share to each other, they each leave it to a trust, which comes into being on the death of the first partner. Until recently, Will trusts were a common way of saving on inheritance tax (IHT). A couple potentially liable for IHT could split their estate into halves, both below the nil-rate band. However, since 2007 married couples and civil partners have been able to transfer unused IHT allowance to one another. As such, most couples no longer need to make this type of trust for inheritance tax purposes, though it may be used to ring-fence the deceased spouse's share from care home assessments.

Will trusts and long-term care

If you use a Will trust and your partner dies, you as the surviving spouse retain a right to live in the house. If you need to pay for care, only your share of the home's value will be assessed by the local authority. The part owned by the trust is not counted. In this way it's protected from care home costs. Government rules (Charging for Residential Accommodation Guide) suggest that this arrangement will not be contested as 'deliberate deprivation', meaning that you have deliberately split your assets to avoid paying high care-home fees.

Will trusts and inheritance

Another reason for setting up a Will trust is to avoid 'sideways disinheritance'. This occurs when the first partner dies, leaving children from the marriage who might reasonably expect to inherit some of the family estate in due course. If the surviving partner remarries and fails to make provision for their children in a new Will, there's a risk that everything will go to their new spouse instead. To avoid this situation, you could set up a life interest trust in your Will, which leaves your share of the family home to your children, while allowing your spouse to carry on enjoying the right to live the property. You should seek legal advice before pursuing this option.

Lifetime trusts

Lifetime trusts are often known as property protection trusts or asset protection trusts. Unlike Will trusts, which come into being on your death, lifetime trusts are established straight away. Your home is gifted to the trust, which allows you to carry on living in it. It is generally not possible to use a lifetime trust to exempt your home from the local authority's calculations of your assets, when assessing your care home costs. Anyone considering setting up a lifetime trust, for this reason, should be aware that a local authority may regard this arrangement as 'deliberate deprivation of assets'. If this is the case, they can assess you as if you still owned the property (and refuse to fund your care).

Lifetime trusts and tax
The tax treatment of lifetime trusts is worth considering carefully. Because you gift the house to the trust, it can attract inheritance tax if it's worth more than the nil-rate band (currently £325,000). Those who transfer their property to a lifetime trust may face an immediate 20% charge on any balance over £325,000 (including gifts made in the previous seven years), while the trustees must submit tax accounts to HMRC. They may have a further tax bill every 10 years, worth 6% of the value over £325,000, plus income tax on any payments from the trust, plus exist charges on assets.

If the trustees sell assets within a trust, these may also be subject to capital gains tax. These may also apply if a trust is liquidated and everything is passed to the trustee. Capital gains tax will be calculated the same way as it is for individuals, though the annual allowance is smaller - £6,000 in 2019-20 and £5,850 in 2018-19.

The exception is if the trust has been set up for a someone disabled - in which case the annual allowance is £12,000 in 2019-20 (and £11,700 in 2018-19). It's always important to seek advice before setting up a lifetime trust, as the tax implications can be significant. This is especially true if the beneficiaries of the trust aren't UK residents, as the rules can quickly become even more complicated.

Discretionary trusts
Will trusts and lifetime trusts can be structured in one of two ways:

- fixed interest, where the first beneficiary has an absolute right to occupy the house and receive the income from any trust investments; or
- discretionary, where the trustees have a pool of potential beneficiaries and have a discretion how to benefit any of the potential beneficiaries.

Usually a discretionary trust also has a letter of wishes for the trustees to consider, which may give one beneficiary the trustees' permission to live in the house or receive the income from investments. The tax treatment of fixed interest trusts is different from discretionary trusts.

And that's it folks…

We hope this guide has helped you think about Inheritance tax liabilities and how these can be possibly minimised beforehand with some careful planning and Estate management. More details about these products and trusts can also be found on our website.

If you have any questions, do not hesitate to give us a call on 07544 320074 or drop us a line at enquiries@legal-ask.co.uk

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