

Briefing document

Wills and inheritance tax

Introduction

It is essential to have a professionally drafted will prepared and executed in order to ensure that wealth is left in a way that meets the testator's overall objectives and best suits the family and friends of the individual concerned. For many people, it is necessary to take Inheritance Tax (IHT) considerations into account when drafting a will to assist in preserving family wealth for future generations.

Failure to execute an appropriate will can cause additional expense for the surviving family and friends.

This briefing note is concerned with the tax effect of general clauses that can be included in a will. Different considerations may apply if you own assets which qualify for business property or agricultural property reliefs and further information on this area is available on request.

Set out below are some of the options which are available to UK resident and domiciled individuals who are considering how to leave assets to surviving family members in order to provide for them after death, and an overview of the IHT position of these options. Appropriate legal advice will also need to be taken and a lawyer appointed to draft any new will or codicil which is required. Different options to those outlined below may be more suitable for non-UK domiciled individuals.

Throughout this note, references to a spouse should be taken to include references to a registered civil partner.

Use of the nil rate band

Every person, regardless of domicile status, is entitled to a nil rate band which can be set against their estate for IHT purposes. 40% IHT is normally payable on death to the extent the value of the estate exceeds the available nil rate band, unless reliefs or exemptions from IHT are available. In particular, UK domiciled spouses are able to leave assets of any value to one another, though the assets would be in the estate of the surviving spouse and, depending on the value of the assets involved, IHT would be payable on the death of the surviving spouse.

In 2020/21 the nil rate band is £325,000 per person, although the band will be reduced if any gifts have been made in the seven years preceding death, unless those gifts qualified for reliefs or exemptions from IHT. The amount of the nil rate band has been frozen at £325,000 since 6 April 2009.

If a married individual does not use his or her entire nil rate band on death, the remaining percentage can be transferred to their surviving spouse for use on his or her eventual death.

Part or all of the nil rate bands available to a couple will be wasted if the surviving spouse does not have sufficient assets to utilise the nil rate band available. With this in mind, it is essential that the terms within an individual's will are checked, as many wills contain a survivorship clause which ensures that a spouse will not inherit if their death occurs within a short period of the first death. This period may typically be 30 days. The interaction of this clause with the transferable nil rate band rules may mean that the surviving spouse cannot utilise the entire nil rate band available on his or her death. An example illustrating this point is below.

Example

- Mr and Mrs Smith, a married couple, have wills that leave everything to each other and include a 30 day survivorship clause. Both nil rate bands (£325,000 each in 2020/21) are fully available as no gifts have been made in the last seven years. The residence nil rate band (see below) is not available to them.
- Mr Smith has assets of £570,000 in his own name and Mrs Smith has assets of £80,000 in her own name.
- Mr Smith dies and this is followed by Mrs Smith's death within the next 30 days.
- The IHT payable by Mr Smith's estate is as follows:

Value of estate	£570,000
Less: nil rate band	(£325,000)
Chargeable	£245,000
IHT @ 40%	£98,000

The value of Mrs Smith's estate is less than the nil rate band, so no IHT is due on her death. She has unused nil rate band of £245,000 (£325,000 - £80,000).

IHT liability (no survivorship clause)

If no survivorship clause had been included, then on Mr Smith's death all of his assets pass to Mrs Smith. The value of her estate on her death is £650,000 (£570,000 plus £80,000). Mr Smith did not use any of his nil rate band (as gifts between UK domiciled spouses are exempt from IHT), so Mrs Smith is entitled to both her nil rate band and his unused nil rate band, so the nil rate band available on Mrs Smith's death is £650,000. As a result, no IHT is payable by the estates of the couple, whereas £98,000 IHT would have been payable had a survivorship clause been included in Mr Smith's will.

Whilst it may be unlikely that both deaths will occur within such a short period, this matter should be reviewed in relation to the specific circumstances, as unexpected charges can arise in some cases.

Residence nil rate band

An additional nil rate band applies where an individual leaves their residence to a direct descendant, such as a child or grandchild. The residence nil rate band is £175,000 in 2020/21.

Individuals can leave up to £500,000 to their descendants without an IHT liability, taking into account both the £175,000 residence nil rate band and standard £325,000 nil rate band. The residence nil rate band is transferable between spouses and is available where the second spouse dies on or after 6 April 2017, irrespective of when the first of the couple died.

The available residence nil rate band is tapered for estates that are worth more than £2million on death. £1 of residence nil rate band is removed for each £2 of the value of the estate over £2million, which means that, in 2020/21, the £175,000 residence nil rate band is reduced to nil for estates worth £2,350,000 or more.

While, as noted above, unused residence nil rate band of the first spouse is available to the estate of the second spouse, it should be borne in mind that, if the second spouse inherits the assets of the first spouse, the available residence nil rate band may be reduced for the estate of the second spouse if the inheritance increases the value of his or her estate such that tapering applies.

A form of downsizing relief is available, where a previous main residence is or was sold on or after 8 July 2015. The rules are complex, and advice should be taken if this may be relevant.

Providing for your spouse

Apart from concerns about using the nil rate band efficiently, it is important to ensure that a will makes adequate provision for the testator's family and in particular for any surviving spouse. There are a number of options available including outright gifts and creating a settlements on death under the terms of a will.

If a settlement is being considered, then whilst this could include the creation of a discretionary trust, a more attractive solution in many cases is an Immediate Post Death Interest (IPDI) trust. Here the gift will qualify for the spouse exemption, so that in most cases there will be no IHT to pay on the death of the first spouse. The surviving spouse must be entitled to receive the income arising under the trust. The value of the assets in the trust will be within the surviving spouse's estate, and so IHT may arise on his or her death. Further detail on the tax position of IPDI trusts is included below.

Settlements for minor children

Parents and grandparents often wish to provide for their children or grandchildren by way of a trust set up by their will. The most popular choices of trusts currently available to parents and grandparents are set out below.

Choices for grandparents

The choice of will trusts for grandparents is limited to:

- *Bare trusts;*
Where a bare trust is established, the trustees hold the income and capital absolutely for the beneficiary. A minor beneficiary will become absolutely entitled to the trust capital and any accrued income at age 18. Ongoing income and gains are taxed on the beneficiaries, so their personal allowances and capital gains tax annual exemptions can be used against this income and gains. No ongoing IHT charges will be payable and the property held on trust for the beneficiary will be within his or her estate for IHT purposes.
- *Discretionary trusts;*
A discretionary trust is a trust under which a class of beneficiaries may potentially benefit, but no beneficiary has a fixed entitlement to income or capital. It is therefore a very flexible arrangement. Trustees will need to pay income tax and capital gains tax at the highest rates of tax on most income and gains they make. The property held on trust will not be within any of the beneficiaries' estates, though IHT charges may arise every ten years and/or on distribution of assets from the trust (though there is an exception from this where assets are distributed from the trust within two years of the testator's death – see the section on discretionary will trusts below).
- *Immediate Post-Death Interest (IPDI) trusts;*
An IPDI is a trust created by will under which a beneficiary has the right to receive the income of the trust. The beneficiary will pay income tax on the income to which he or she is entitled at his or her marginal income tax rate. The trustees will pay 20% capital gains tax on most capital gains they make, however a 28% rate applies to the disposal of residential property and carried interest in private equity structures. IPDI trusts are not subject to the ten year and exit IHT charges that apply to most other types of trust. However, the trust property is treated as forming part of the beneficiary's estate for IHT purposes and could be subject to IHT on his or her death.

Further choices for parents

The choice is wider for parents and in addition to the three trusts above includes:

- *Trusts for a Bereaved Minor (TBM);*
These are usually established on the death of a parent while the child is under 18. The child must become entitled to the income and capital of the trust at age 18. Until then the child could have a right to receive trust income, though this is not required. The trust income can only be applied for the maintenance or benefit of the child. The income and capital gains tax position while the beneficiary is a minor will be as set out for discretionary trusts above, though if the beneficiary is entitled to receive trust income the tax analysis would instead be as set out for IPDIs above.

TBMs are not subject to IHT ten year and exit charges, so trust assets can be distributed absolutely to the beneficiary without a charge to IHT. Once distributed, the trust property forms part of the child's estate for IHT purposes.
- *18-to-25 trusts.*
These are similar to TBMs except the beneficiary need not become absolutely entitled to the trust income and capital until age 25. However this extra protection comes at an IHT cost. IHT exit charges apply between ages 18 and 25, such that a distribution at age 25 will attract a maximum IHT charge of 4.2% of the value of the trust's assets.

The income tax, capital gains tax and IHT treatment of each of the above options varies significantly. If you wish to provide for your children or grandchildren in your will it is important that you discuss your circumstances in detail with your Deloitte contact and legal adviser, to ensure that the strategy put in place is suitable.

Discretionary will trusts

Some individuals may not wish to commit to a set distribution of assets in their will, instead retaining flexibility over how their assets will be distributed.

If assets are left to a discretionary trust but are distributed by the trustees within two years of death, the distributions are effectively treated for IHT purposes as though the will had provided for outright gifts to be

made to the recipient(s) of the trust distributions. This can therefore provide extra flexibility where the individual is not yet certain to whom he or she would like to leave assets. The income tax and capital gains tax positions where assets are distributed by trustees in these circumstances may vary from the positions which would have applied had outright bequests been made.

Bequests to charity

Many individuals consider including a bequest to charity in their wills. Gifts to qualifying charities are exempt from IHT. Furthermore if at least 10% of the individual's net estate is left to charity, the IHT rate for the remainder of the estate is reduced to 36%. A separate briefing note is available on request.

Find out more...

This note reflects the law in force as at 8 April 2020. Please be aware that it does not cover all aspects of this subject. To find out more about any aspect of the above, please discuss with your usual Deloitte contact. If you do not have a usual contact, please contact Patricia Mock (pmock@deloitte.co.uk).

For further information visit our website at www.deloitte.co.uk.

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