

INHERITANCE TAX and the PRE-BUDGET REPORT 2007

How will this affect you?

The Pre-Budget Report 2007 has been heralded as making the greatest change to Inheritance Tax since this tax was introduced in 1986. Headlines announce that Inheritance Tax thresholds have been 'doubled'. Yet, are the changes really that sweeping, will couples really be able to leave £600,000 tax-free when they die and, most importantly, how will these new rules affect you?

This is our understanding of the new rules at 23 October 2007 as they affect persons domiciled in the United Kingdom.

(Please note that the proposed new legislation is currently in the form of a Finance Act yet to be ratified by Parliament. The new Finance Act will be passed in Summer 2008 and is subject to change until then; some changes may therefore well be made to the proposed new rules contained in the Pre-Budget Report which is the subject of this article.)

The new law will apply to married couples; it will also apply to widows, widowers and surviving civil partners who were alive on 9th October 2007 but will do so regardless of how long ago their spouse or civil partner died. It will not apply to co-habitees, single persons or divorcees.

Although the change in the law will work to the benefit of most people, there are situations where it will be necessary for you to take action. Furthermore, the affect of the new rules is far-reaching and even if you may at first think that the new rules do not apply to you, you may be affected by the consequences of the rules due to the variety of permutations where they will apply, some of which are illustrated below.

Current Law

Under current law and also the new law, when someone dies, their estate is entitled to a 'Nil-Rate Band' – an amount which is chargeable to Inheritance Tax (IHT) at 0 per cent. Everything above this amount is subject to IHT charged at 40 per cent. In the tax year 2007/08 the amount of the Nil-Rate Band is £300,000.

However:

- > the Nil-Rate Band may be reduced if you have given away money or any other assets in the seven years prior to your death, other than to your spouse or civil partner, or if you leave legacies in your will, free of IHT.
- > if you leave your estate to your spouse, civil partner (provided that they are domiciled in the UK) or to charities then no IHT is payable on these bequests.

At present, when someone dies leaving their estate to their UK domiciled spouse or civil partner there will be no IHT payable on the first death; only £55,000 passing from a UK domiciled to a non-UK domiciled spouse is exempt. Provided the survivor was not subject to this restriction then the first of the couple to die has not used their Nil-Rate Band and it dies with them. When the surviving spouse or civil partner dies, they have their own Nil-Rate Band.

Proposed New Law

Under the proposals, the concept of *transferring* the Nil-Rate Band between spouses and civil partners has been introduced.

The new rules will allow any Nil-Rate Band unused when the first spouse or civil partner died to be used when the surviving spouse or civil partner subsequently dies.

The amount of the Nil-Rate Band available for transfer will be based on the *proportion* of the Nil-Rate Band that was unused when the first spouse or civil partner died.

This is best explained by some examples:

- > **EXAMPLE 1:** Husband died in 2007 and left the whole of his estate to his wife. He did not use his Nil-Rate Band because the surviving spouse exemption applied. In 2010 his widow dies and the Nil-Rate Band is then £350,000. As the Husband had 100% of his Nil-Rate Band unused, the Nil-Rate Band of his widow will be increased by that proportion. Thus, her Nil-Rate Band will be increased by 100% and she will be able to leave £700,000 tax free (£350,000 + £350,000).
(NB the value of the Husband's estate is irrelevant. If he left £100,000 or £1 million to his wife the same proportion would be applied on her death)
- > **EXAMPLE 2:** If however, the husband died in 2007 when the Nil-Rate Band was £300,000 and had given away £150,000 in tax-free legacies in his Will (or by gifts during the seven years prior to his death), he would have used up 50% of his Nil-Rate Band, leaving 50% unused. In 2010 when the widow dies and the Nil-Rate Band is £350,000, her Nil-Rate Band will be increased by 50% and she will be able to leave £525,000 tax-free (£350,000 + £175,000).

It is important to note:

- > these rules apply whether there is a Will or no Will an intestacy.
- > these rules do not apply where a couple both died before 9th October 2007.
- > on transfer, the proportion of the unused Nil-Rate Band on the first estate is the relevant consideration, not the value of the estate nor the actual amount of the Nil Rate Band.
- > the transfer is not automatic - the claim to transfer an unused Nil-Rate Band is made by the personal representatives of the surviving spouse or civil partner.
- > it will be necessary to find out what proportion of the Nil-Rate Band was unused on the first death – so for deaths before the 9th October 2007 old records will need to be examined; and for deaths after this date records will need to be kept.
- > the Nil-Rate Band can only be increased by a maximum of 100%. It cannot be increased by more than this. Therefore particular careful planning is necessary for those who have been widowed and re-married and for those married to someone who has previously been widowed
- > these rules do not apply to co-habitees.

The new rules will allow unused Nil-Rate Bands to be transferred from more than one deceased spouse or civil partner, up to a limit of one additional Nil-Rate Band.

So, if someone has survived more than one spouse or civil partner, then when that person dies, a claim may be made for an increased Nil-Rate Band from more than one other estate. But, the additional Nil-Rate Band in these circumstances is limited to a maximum of the amount of the Nil-Rate Band in force at the relevant time.

An example to illustrate this is:

- > EXAMPLE 3: Mr X dies in 2007 when the Nil-Rate Band is £300,000. His estate is £250,000. He leaves £120,000 to his son and £130,000 to his wife Mrs X. He therefore has 60% of his Nil-Rate Band unused – (i.e. the legacy to his surviving spouse is exempt from IHT and the legacy to his son used up 40% of his Nil-Rate Band: £120,000 of £300,000 is 40%, leaving 60% unused).

Mrs X later marries Mr Z who dies in 2008. Mr Z also leaves 60% of his Nil-Rate Band unused at his death. Mrs X has been widowed twice and both husbands had 60% of their Nil-Rate Bands unused when they died.

Mrs X (now Mrs Z) dies in 2009 when the Nil-Rate Band is £325,000. Her estate is £700,000. Mrs Z's personal representatives make the claim to transfer the unused Nil-Rate Bands from the estates of both her husbands, Mr X and Mr Z. However, the amount of the increase is limited to 100% of the Nil-Rate Band in force at the time.

So Mrs Z's Nil-Rate Band is increased by 100% only and her Nil-Rate Band is £325,000 plus £325,000 giving a total of £650,000, meaning that IHT at 40% is charged on only £50,000 of her estate.

What action do you need to take now?

1. If you have been widowed or your civil partner has died and you have remarried or entered into a further civil partnership:

The new rules affect you. You should review your Will with your solicitor now. If you have not made a Will, you should take advice.

You will need to consider:

- > Whether you wish to preserve the additional Nil-Rate Band which you are entitled to from the death of your first spouse in the event that you are the first to die in the second marriage, by creating a Nil-Rate Band Discretionary Trust on your death. (Your surviving spouse may re-marry and the benefit of your increased Nil-Rate Band may be lost or reduced).

The rules for transferring unused Nil-Rate Bands only apply where the marriage or civil partnership ended by the death of one party. If the previous marriage or civil partnership was ended by divorce or dissolution, and your former spouse or civil partner subsequently died, then these transfer rules do not apply to you.

2. If you have children from a previous marriage (whether it ended by divorce or death) or from a previous relationship and you have re-married or entered into a new civil partnership:

You will need to consider:

- > whether you want your unused Nil-Rate Band to be transferred to your new spouse's or civil partner's estate if they survive you. (There maybe children of the first marriage that you wish to benefit from the allowance instead for example.)

3. If you are married, in a civil partnership (or made a Will in contemplation thereof) or are widowed or your civil partner has died and you have:

- (a) included a legacy in your Will of a cash sum calculated by reference to the Nil-Rate Band; or
- (b) made legacies intended to use up the Nil-Rate Band in your Will:

You should review the wording of the cash legacy in the Will with your solicitor.

You will need to consider:

- > whether the wording used would result in the amount payable exceeding your wishes if, for example, you have or may have an additional Nil-Rate Band on your death transferable from your former spouse.
- > whether you wish to use up your Nil-Rate Band with legacies on your death, or whether you wish to leave an unused Nil-Rate Band to be transferred to your surviving spouse or civil partner on their eventual death. However, by the time of the second death the rules may have been repealed and the benefit of a Nil-Rate Band on the first death will have been lost, or your spouse may re-marry and the benefit of your Nil-Rate Band may be lost or reduced.

4. If you have included a Nil-Rate Band Discretionary Trust in your Will:

You do not need to change your Will.

Many people have made Wills to include Nil-Rate Band Discretionary Trusts to be set up on the first death to preserve the Nil-Rate Band of the first spouse to die, thereby achieving broadly the same result as the new legislation.

Where someone dies on or after 9th October 2007 with a Nil-Rate Band Discretionary Trust in their Will, an appointment of the trust assets in favour of the surviving spouse or civil partner (before the second anniversary of the death, but not within the three months immediately following the death) would normally be treated for IHT purposes as if the assets had simply been left to the surviving spouse or civil partner outright.

Ending the trust in this way would mean that the Nil-Rate Band was not used on the first death, and so the amount available for eventual transfer to the surviving spouse or civil partner would be increased accordingly.

However your trustees may wish to consider, at the time of the first death, whether it may be advantageous to continue with the trust in any event, having regard to the taxation laws and your family's personal and financial circumstances at the time; having the option to set up this type of trust on the first death may turn out to be very useful to your family.

Some advantages of a Nil-Rate Band Discretionary Trust are:

- (a) that it does ensure that your Nil-Rate Band is preserved should your surviving spouse re-marry or the laws change.
- (b) assets put into the Nil-Rate Band Discretionary Trust on the first death may increase in value more than future increases in the Nil-Rate Band available on the second death.
- (c) there is a tax-saving advantage for business and agricultural property when it is put into this type of trust.

- (d) assets put into the trust may protect the family home from liability for care home fees.
- (e) it may be desirable to have a trust for children or grandchildren.

5. If you have included an Immediate Post Death Interest in your Will:

You do not need to change your Will.

- > If you have left assets on trust with a life interest for your surviving spouse or civil partner, with the remainder passing on the death of that person to someone else (for example children), there is no IHT payable on the first death because of the surviving spouse or civil partner exemption.
- > So, if the entire estate is left in trust to the surviving spouse or civil partner, the Nil-Rate Band would be available for transfer to the estate of the survivor on their eventual death in the same way as if the estate had been left to them absolutely.

6. If you are thinking of changing your Will, or are thinking of making a Will for the first time:

If your circumstances have changed and you need to change your Will, or you want to make a Will for the first time, your solicitor will be able to advise you on how the new rules will affect you.

If you are married or in a civil partnership then you may wish to consider:

- > having simple Wills and rely on the new rules for IHT saving; if, for example, your combined assets do not exceed £600,000.
- > having the option of a Nil-Rate Band Discretionary Trust in your Wills; if, for example your combined assets are in excess of £600,000 and you have significant assets not tied up in the family home, or if there is a possibility that either of you may re-marry.

7. If you are considering life-time tax planning:

You should take advice from your solicitor or accountant.

Using up your Nil-Rate Band in your lifetime reduces the amount available on your death and the proportion available to be transferred to your surviving spouse or civil partner on their eventual death.

8. If your spouse has died within the last two years:

You should take advice from your solicitor now.

Deeds of Variation can be completed within two years of a person's death and vary the Will of the deceased. If their death occurred within the last two years a Deed of Variation may be an effective way of ensuring that assets pass in the most tax efficient manner.

9. If you are in the process of carrying out a Deed of Variation:

You should take advice from your solicitor now.

If you are currently in the process of carrying out a Deed of Variation on the estate of someone who has been survived by a spouse or civil partner, the Deed may no longer be tax efficient.

10. If your spouse or civil partner has died and a Nil-Rate Band Discretionary Trust was included in their Will:

- (a) If your spouse or civil partner died over two years ago and you have already set up a Nil-Rate Band Discretionary Trust, then their Nil-Rate Band has been used. Your family will have benefited from the tax-saving.
- (b) If your spouse or civil partner died within the last two years and you have not yet set up the Nil-Rate Band Discretionary Trust, or it has been set up

You may want to consider:

- > if you think that you are likely to marry again, it may be sensible to set up the Nil-Rate Band Discretionary Trust to ensure that your spouse's unused Nil-Rate Band is not lost, and is secured.
- > if you think that the Nil-Rate Band at the time of your death will rise significantly, you may decide not to continue with the Nil-Rate Band Discretionary Trust and your estate benefit from an increased Nil-Rate Band on your death which in certain circumstances may be doubled.
- > if you think that assets put into a trust would increase in value more than the possible increase in the Nil Rate Band Discretionary Trust then you may want to continue with the trust.

Conclusion

As you can see, the proposed changes to the law allow for the possibility of married couples and civil partners saving considerably more IHT than they have in the past. Please be aware however that effective tax planning measures will still be required to ensure that the maximum savings are made.

If you are in any doubt as to whether your current Will meets your wishes and if you wish to know more about the new rules, you should ask your solicitor to review your Will. A charge may be made.

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