NIL RATE BAND DISCRETIONARY TRUSTS – ARE THEY OF ANY USE NOW?[1]

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Introduction

Prior to the announcement of the transferable nil rate band ("NRB") in October 2007 the problem for the average middle income client who had a house and a small amount of capital was how to preserve the NRB of the first spouse to die.

Example

In his will husband leaves everything to wife.

Husband dies.

In her will wife leaves everything to the children.

Wife dies.

If both spouses gave everything to each other, and the husband died first, all his property went to his wife, and no IHT was payable because of the spouse exemption. When the wife died, all her property and that inherited from her husband went to the children. The wife's NRB was available, but the husband's had been lost. This does not now happen if the wife dies after 9 October 2007 as the wife's estate will have the benefit of the husband's unused nil rate band.

Various ways were devised to preserve the nil rate band of the first spouse to die, but the most popular one was a will creating a nil rate band discretionary trust. The surviving spouse and children would be within the class of beneficiaries, and the

1 This article is based on chapter 25 of "Estate Planning for the Middle Income Client" by the author and published by Bloomsbury Professional.

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residue would either be given to the surviving spouse absolutely, or the surviving spouse would have a life interest in the residue. The trustees would be empowered to accept an IOU from the surviving spouse for the nil rate band legacy, or to impose a charge.

Example

The wife gives a NRB legacy to the trustees of a discretionary trust, the residue to the spouse.

The trustees are empowered to accept an IOU from the surviving spouse or impose a charge for the NRB legacy.

The wife dies.

The trustees of the NRB discretionary trust accept an IOU from husband.

The husband dies leaving an estate of £1,000,000.

It is hoped that the IOU or charge for the NRB legacy will be deductible.

Assuming the NRB is always £325,000, the husband's taxable estate will be reduced to £350,000 − £1000.000 minus the IOU or charge for £325,000 minus the husband's NRB of £325,000.

Other reasons for creating nil rate band discretionary trusts than preserving the nil rate band of the first to die.

Whilst the main reason for using these wills was to preserve the NRB rate band of the first spouse to die, occasionally there were other reasons for these wills. Concerns about care home fees, second marriages, generation skipping, or spouses, civil partners, or cohabitees with an alcohol, drugs or gambling problem may mean that these wills are still appropriate.

Care home fees – if the surviving spouse or civil partner or cohabitee is likely to have to become resident in a care home, his or her assets can be used to pay care home fees, but what is in a nil rate band trust created on the death of the first spouse cannot usually be taken.

If the clients are in second, or third marriages, or civil partnerships, or relationships with children from previous marriages, then they may want at least some of their assets to go back to the children of previous relationships.

If they create NRB discretionary trusts with the surviving spouse or civil partner or cohabitee, and the children, and grandchildren of previous relationships within the class of beneficiaries, it ensures that those children or grandchildren will get something at the end of the day. On the death of the surviving spouse, the trustees can then appoint the assets to the children or grandchildren of the first marriage. There is also the advantage of flexibility. It may be that a child within the class of beneficiaries under a discretionary trust is in a dodgy financial state, or has a dodgy marriage, or is in receipt of some means tested benefit – not a good idea to appoint a large chunk of assets to that child – or is wealthy and does not need anything so that assets can be appointed directly to grandchildren.

In addition, if clients are concerned about his or her spouse remarrying, or civil partner entering into another civil partnership or another relationship, then again NRB discretionary trusts will ensure that the children of the relationship get something at the end of the day.

If a spouse or civil partner or cohabitee has an alcohol or gambling problem, again, these wills again can be used to ensure that the children or grandchildren get something .

Another reason for suggesting these wills to clients is that there could be a larger saving in IHT if an asset is vested in the trustees which increases in value considerably than could be obtained by making use of the transferable NRB.

Example

1. Spouse 1 dies leaving everything to spouse 2.

The NRB when spouse 1 dies £300,000; when spouse 2 dies £350,000.

Double NRB available on spouse 2's death – £700,000.

2. Spouse 3 dies leaving a will creating nil rate band discretionary trusts, with the residue to spouse spouse 4.

NRB when spouse 3 dies £300,000; when spouse 4 dies £350,000.

Half share in the matrimonial home is worth £300,000 on spouse 3's death, and is appropriated in satisfaction of the NRB legacy..

When spouse 4 dies half share is worth £500,000. spouse 4's other assets are £700,000

IHT saving is £350,000 + £500,000 = £850,000

The downside to this is that the trustees will incur a liability to capital gains tax unless the gain is covered by the private residence exemption, and there is a possibility of creating an immediate post death interest in favour of the surviving spouse; these issues are discussed below. In addition, there could be a liability for ten yearly charges and an exit charge.

Another possibility is to encourage the surviving spouse to make PETs.

This depends on the surviving spouse being able to do so.

If in the previous slide, spouse 2 had made a PET of £300,000, and lived for seven years, then that would also be exempt from IHT.

It may also be possible to create the 'super NRB discretionary trust'.

1. Spouse 1 creates an NRB discretionary trust with all the necessary powers. Spouse 2 and three children of the marriage are within the class of beneficiaries.

2. The residue goes to spouse 2 on an immediate post death interest, remainder to the children.

3. On spouse 1's death, half share in the matrimonial home worth £300,000 + £30 is transferred to trustees of NRB discretionary trust.

4. Trustees then create another IPDI in favour of spouse 2 and transfer spouse 1's half share in the house to that trust. This will be read back into the will so that spouse 1 will be deemed to have created the IPDI, and the spouse exemption will operate.

5. The trustees then sell spouse 1's interest in the house to spouse 2 in return for a loan note which could be index linked or bear interest.

6. Spouse 2 then surrenders her life interest. This is PET of the loan note.

Spouse 1's NRB is preserved, and in addition there is a debt due from spouse 1's estate.

All steps must take place within two years of death, and there may be SDLT implications.

This scheme is complicated, and most clients do not like complicated schemes.
It is also artificial and the Revenue might seek to challenge it.

Remarriage

If a surviving spouse remarries, then if all spouses predecease, the surviving spouse will be able to carry forward the unused NRB of all predeceased spouses, with an overall limit of double the NRB for the tax year when the surviving spouse dies. This means that if a spouse remarries, and all his or her spouses predecease leaving everything to the surviving spouse, then the nil rate bands of the previous predeceased spouses apart from one will be lost.
If the surviving spouse does remarry, a will making use of the NRB of the first spouse may result in a larger saving in IHT.

Example

Assume NRB is £300,000.

Spouse 1 dies having created a NRB discretionary trust with power for the trustees to take an IOU/impose a charge, residue to spouse 2.

Trustees impose a charge for £300,000.

Spouse 2 marries spouse 3.

Spouse 3 dies leaving all assets to spouse 2.

Spouse 2 dies leaving an estate of £1m.

Charge for £300,000 deductible plus double the NRB available on the death of spouse 2.

If Spouse 1 had left everything to spouse 2, then if spouse 2 remarries within two years of the death of spouse 1, then spouse 2 could vary spouse 1's will so as to create a NRB discretionary trust.

What is the position if spouse 1 leaves everything to spouse 2, and spouse 2 marries spouse 3 more than two years after the death of spouse 1?

If spouse 3 predeceases spouse 2, and leaves everything to spouse 2, spouse 1's NRB will be lost as the maximum NRB which is available on the death of spouse 2 is double. In this situation, it may be that spouse 2 should leave a will giving double the NRB available on spouse 2' s death to trustees with power to take an IOU, or accept a charge.

When spouse 2 dies, full use will then be made of spouse 1's NRB. spouse 3 then dies, spouse 3 can make use of spouse 3's NRB, and possibly a previous spouse's NRB.

As it is uncertain who will die first, spouse 3's will should contain a NRB discretionary trustee (possibly double if spouse 3 can make use of transferable NRB from the death of a previous spouse), with remainder to spouse 2. If spouse 3 dies first, that trust can then be implemented, and when spouse 2 dies, spouse 2's estate will still have the benefit of spouse 1's NRB.

Example

Assume the NRB is £300,000 when spouse 1 dies, and when spouse 2 or spouse 3 die £350,000/£375,000.

Spouse 1 dies leaving all assets to spouse 2.

Spouse 3 dies leaving all assets to spouse 2.

On spouse 2's death, NRB is £700,000. spouse 1's NRB has been lost.

Example

Spouse 1 dies leaving all assets to spouse 2.

Spouse 2 makes will with discretionary trust and gives the trustees a double NRB legacy, residue absolutely to spouse 3, or IPDI, substitution gift to children.

Spouse 3 has similar will.

Spouse 2 dies.

Trustees take an IOU or impose a charge for double NRB. No IHT because of NRB and spouse exemption.

Spouse 3 dies.

IHT saving – Double NRB =£700,000 + £375,000 = £1,075,000.

In addition, if spouse 3's first spouse left everything to spouse 3, then double nil rate band will be available on spouse 3;s death.

Cohabitees

The creation of an NRB discretionary trust with power for the trustees to accept an IOU or impose a charge will reduce the amount of IHT payable on the death of the second. Indeed, far more could be put into the discretionary trust without adversely

affecting the amount of IHT payable on the death of the first cohabitee, but substantially reducing it on the death of the second.

Example

Assume NRB is £300,000.

Cohabitee 1 leaves an estate of £800,000.

IHT at 40% on £500,000 = £200,000.

Cohabitee 2 leaves £600,000 inherited from cohabitee 1 plus £400,000 personal estate.

IHT at 40% on £700,000 = £280,000,

If cohabitee 1 had created an NRB discretionary trust and given the trustees power to accept an IOU from cohabitee 2 or impose a charge, with the residue to cohabitee 2 on cohabitee 2's death –

IHT payable on £400,000 personal estate plus £600,000 inherited from cohabitee 1 less IOU for £300,000 less NRB = 40% on £400,000 = £160,000.

This idea will also work if far more than the NRB is given to the trustees.

Example

If cohabitee 1 had created a discretionary trust and given legacy to trustees of £500,000 and had given trustees power to accept an IOU from cohabitee 2 residue to cohabitee 2 on cohabitee 2's death –

IHT payable on £400,000 personal estate plus £600,00 inherited from cohabitee 1 less IOU for £500,000 less NRB = 40% on £200,000 = £80,000

However, there might be a ten yearly charge to IHT, and also an exit charge when the trust is broken up. The maximum rate payable on ten yearly charges and exit charges is 6%, and so the trust would have to last for a considerable number of years before these charges exceeded the saving.

Various issues concerning nil rate band discretionary trusts.

(a) The debt can be index linked, or might be expressed as a proportion of the value of the property. It is probably better if it is secured by a charge because an IOU might prove to be worthless on the death of the

surviving spouse, and also to avoid stamp duty land tax; this is discussed later.

(b) There is a possibility of a charge on each tenth anniversary, and also on distributions of capital. The amount of IHT payable should be small as the rate of IHT payable on the tenth anniversary is 6% once the NRB has been exceeded. However, with all NRB discretionary trusts, it will be necessary to value all the assets in the trust on the first tenth anniversary of the death of the first spouse, and every subsequent tenth anniversary. In order to determine the rate of tax, it is necessary to know the NRB for the tax year when the tenth anniversary falls. Assuming that the settlor has not created any other trusts in the seven years prior to death, or created any related settlement in the will and that there have been no payments of capital from the trust in the ten years leading up to the tenth anniversary, the NRB will be intact. If the value of the assets within the trust is within the NRB, then no IHT will be payable. If the value of the assets is in excess of the NRB, then IHT is payable at 6% on the value above the NRB.

Historically the NRB usually increases at slightly more than the rate of inflation each year, so if the IOU or charge is just for the amount of the NRB at the date of death, there will be no ten-yearly charge as the IOU or charge will be within the NRB. However, if the IOU or charge is linked to the RPI or CPI or expressed as a proportion of the value of the house, or there are other assets in the trust, then there is a possibility that the IOU or charge and the other assets will be worth more than the NRB on the tenth anniversary. If it is, IHT is payable on the excess over the NRB, or what is left of it.

Example

The IOU is for the NRB—it should be within the NRB for the tax year in which the tenth anniversary falls.

If the IOU is linked to the RPI, or expressed as a proportion of the value of the house, and is worth £500,000 on the tenth anniversary, IHT is payable at 6% once the NRB has been exceeded.

Thus if the NRB is £400,000 in the tax year in which the tenth anniversary falls, IHT at 6% will be payable on £100,000, assuming that nothing has reduced the NRB.

(c) Be careful about creating another settlement in the will unless it is a life interest in favour of the spouse. Both settlements will be treated as related, and may adversely affect the IHT payable on the settlements.

(d) If the trustees did not impose any obligation on the surviving spouse to pay interest at a commercial rate, there was a risk that HMRC would argue that he or she had an interest in possession. The trustees have in effect made a loan to the surviving spouse of the amount of the IOU or charge. If the surviving spouse did not have to pay interest, then the surviving spouse is obtaining the loan free of charge, and therefore has an interest in possession in the amount of the IOU. This meant that when the surviving spouse died, he or she would be deemed for IHT purposes to have disposed of the value of the NRB.

If the IOU or charge does bear interest, it will have income tax consequences if the trustees insist on the payment of the interest, and so it may be best if the trustees do not insist on the payment of interest each year, but instead roll the interest up and claim the rolled-up interest as a debt due from the estate of the surviving spouse reducing the estate of the surviving spouse as far as IHT is concerned. There would then be a liability for income tax on the rolled-up interest. Alternatively the trustees could waive the interest. This aspect is discussed in more detail later.

Another possibility to avoid this problem was to index link the loan, or express it as a proportion of the value of the house.

This point may not be open to HMRC in the light of the changes to the taxation of trusts in FA 2006. All trusts will now be subject to the relevant property regime unless they are immediate post death interests, trusts for bereaved minors or trusts for disabled persons.

These trusts are clearly not immediate post death interests or trusts for disabled persons which are the only two trusts left where the beneficiary will be deemed to have an interest in possession.

(e) There is also a problem if the surviving spouse has made gifts to the first spouse to die.

The problem is that there are anti-avoidance provisions in FA 1986 designed to counteract artificial debts. A debt is not deductible if the consideration for it consisted of property derived from the deceased. These provisions apply if one spouse has made gifts to the other. This is quite common with clients in their seventies and eighties—40 or 50 years ago it was common for houses to be vested in the name of the husband, whereas now most houses are vested in the joint names of spouses or cohabitees. As times changed, the husband might have transferred the house into joint names. If the spouses then make wills creating NRB discretionary trusts, and giving the trustees power to accept an IOU, and the wife dies first, the HMRC may claim that this is an artificial debt. The artificial debt rules

may also apply where there is a discrepancy in wealth between the spouses, and the wealthy spouse has transferred assets to the other spouse, and the wealthy spouse is the survivor. They could also apply where one spouse has inherited assets, and used them to redeem the mortgage on the matrimonial home if that spouse is the survivor.

Example

Assume the NRB is £300,000.

The husband has given a half share in the house to wife.

Assume that the half share is worth £300,000, and that wife has no other assets.

The wife dies having created an NRB discretionary trust in her will, and conferred appropriate powers on the trustees.

The husband gives the trustees an IOU for the NRB legacy.

The executors vest the wife's assets, the half share in the house, in the husband.

The trustees have made him a loan of £300,000 in consideration of the transfer of the wife's assets to him.

As these assets came from husband originally, the debt is artificial, and cannot be deducted from the husband's estate on his death.

In *Phizackerley v HMRC* [2007] UKSPC SPC00591 on his retirement in 1992, the deceased and his wife purchased a house for £150,000. The house was conveyed to them as joint tenants. There was a mortgage of £30,000 which was repaid in 1994. The wife did not have any paid employment throughout the marriage, and accordingly all the funds for the house were provided by the deceased.

In May 1996 the joint tenancy was severed. In the same month, the wife executed a will creating an NRB discretionary trust and giving the trustees power to take an IOU.

The wife died in April 2000, and the deceased promised to pay the trustees of the NRB discretionary trust £150,000 (index linked). All the assets of the wife were then vested in the deceased.

The deceased died in July 2002. His personal representative sought to deduct the IOU, which was now worth £156,013 from his estate.

HMRC contended that this was an artificial debt within FA 1986 s 103 and was not deductible. The Special Commissioner held that this was correct.

It was argued on behalf of the personal representative that the artificial debt rules did not apply as the gift to the wife was not a transfer of value because it came within ITA 1984 s 11 being a disposition for the maintenance of the family.

The Special Commissioner held that the gift of the half share was not for the maintenance of the wife with the result that the IOU was not deductible from the estate of the husband.

Note that there would have been no problem if the husband had died first.

The artificial debt rules only apply if it is the deceased who has created the debt. In view of this, it has been suggested that the way round this is to give the executors power to vest assets in a beneficiary subject to a charge for the NRB legacy. As it is the executors who have created the charge, there is no problem with the artificial debt rules. However, this could cause another problem if the surviving spouse wants to move house. The surviving spouse could agree with the trustees that he or she will grant another charge on the new house. However, this could trigger the anti-avoidance provisions contained in FA 1986 s 103.The surviving spouse is creating a new charge in place of one created by the trustees. The consideration for the original charge was provided by property derived from the surviving spouse—therefore, the anti-avoidance provisions are triggered.

If this is likely to be a problem, the residue should be given to trustees to hold on trust for the surviving spouse for life. The residue would include the equitable interest of the first spouse to die in the house.

The legal estate will vest in the surviving spouse, and if the surviving spouse wants to sell, he or she can do so by appointing a new trustee as two are required to give a valid receipt for capital unless a restriction has been entered at the Land Registry protecting the interests of the trustees of the NRB discretionary trust. It may be that the surviving spouse will be able to purchase his or her new house with his or her half share of the proceeds of sale and other assets, and so there is no problem. The trustees of the NRB discretionary trust will receive enough of the proceeds of sale of the house to enable them to discharge the charge. Those proceeds can either be invested or distributed. If that is not the case, then the trustees will have to permit the surviving spouse to utilise the half share of the proceeds of sale or at least part of it. The trustees of the residue will acquire an equitable interest in the new house, and can give the trustees of the NRB discretionary trust a charge over the equitable interest in the new property. As it is the trustees and not the surviving spouse who have created the charge, the anti-avoidance provisions should not be triggered.

Example

The husband has given a half share in the matrimonial home to his wife. The wife dies having created an NRB discretionary trust in her will.

The wife appointed child 1 and child 2 as executors, and the husband, child 1 and child 2 as trustees of the NRB discretionary trust.

The residue has been given to child 1 and child 2 to hold on trust for the husband for life, then to child 1 and child 2.

Child 1 and child 2 will take the wife's equitable interest in the matrimonial home, and can create a charge in favour of the husband, child 1 and child 2.

If the husband wants to move house, he can sell by appointing another trustee.

Child 1 and child 2 then permit the husband to have some or all of what is due to them, and will acquire an equitable interest in the new house. They can then give the husband, child 1 and child 2 a charge over their equitable interest in the new house.

In *Phizackerley* if the wife's executors had imposed a charge on the wife's equitable interest in the house, and vested the equitable interest in the husband, it may be that there would have been no problem with the artificial debt rules as it was not the husband who was creating the charge but the wife's executors. In addition there would have been no problem if the husband had died first.

Another simple solution to the problem might be for the executors of the first spouse to die to vest the equitable interest of the first spouse in the matrimonial home in the names of the trustees of the NRB discretionary trust. If the surviving spouse wants to move house, then the trustees could join in the sale of the former matrimonial home and the purchase of a new house. The trustees would get an equitable interest in the new house of the surviving spouse.

There may be problems with this idea. The first problem is ITA 1984 s144.

This provides that if there is a discretionary trust in the will, and there is an event which would give rise to a charge to IHT within two years of the death of the testator, it is treated as if the testator had disposed of the assets in accordance with the event. As with deeds of variation within two years of death, the event is read back into the will. An appointment out of a discretionary trust in a will within two years of death is an event which would normally give rise to a charge to IHT. Accordingly, an appointment out of the trust within two years of the death of the testator is treated as if the testator had disposed of the assets in accordance with whatever appointment the trustees make. If the executors of the first spouse to

die vest the equitable interest in the matrimonial home of that spouse in the trustees of the NRB discretionary trust, and the trustees acquiesce in the surviving spouse living in the house, does that constitute an appointment out of the trust? If it did, then the surviving spouse would have an immediate post death interest in the half share of the first spouse to die, and that would be part of his or her estate on death.

This is a grey area, but it is possible that HMRC will accept that mere acquiescence by the trustees in the surviving spouse remaining in occupation of the matrimonial home is not an appointment, or an event, within s 144. It is also arguable that the surviving spouse is in occupation not under the trust, but because he is a tenant in common, and is entitled to occupy the whole property because of this. However, there is clearly a risk that HMRC might take the point (see Questions by STEP/CIOT and answers from HMRC to FA 2006 Sch 20 (January 2007).

The solution may be to wait two years from the death of the first spouse before vesting the equitable interest of the first spouse into the names of the trustees of the NRB discretionary trust.

With both these ideas for getting around the anti-avoidance rules to do with artificial debts, it may also be that when the house is sold, the trustees of the NRB discretionary trust will not be able to claim private residence exemption for any gain accruing to them. Taxation of Chargeable Gains Act s 225 provides that if trustees are holding a house, and under the terms of the settlement, it becomes the principal private residence of that beneficiary, when the house is sold, the trustees can claim private residence exemption. However, there is a considerable element of doubt as to whether the trustees holding an equitable interest in a house where the surviving spouse has the other equitable interest have power to permit the surviving spouse to live in the former matrimonial home. If the trustees do not have such power, then s 225 does not apply, and accordingly the trustees will not be able to claim private residence exemption on any gain on the half share vested in them. In addition, it is arguable that the surviving spouse is living in the house not under the terms of the trust but because of the equitable interest of the surviving spouse.

On the other hand, if the residue is an immediate post death interest for the benefit of the surviving spouse, when the surviving spouse dies there will be a free uplift for CGT purposes of all the assets in the trust. Accordingly, if the half share of the first spouse to die is vested in the names of the trustees, when the surviving spouse dies, no CGT will be payable, but instead the remainder men, usually the adult children, will acquire that half share at market value as at the date of death of the surviving spouse.

Another possible way of implementing these NRB discretionary trusts is to wait until two years have elapsed from the death of the first spouse and then appoint the half share of the house on a life interest trust for the benefit of the surviving spouse. As it is not an immediate post-death interest, HMRC cannot argue that there is an interest in possession. Why wait two years? If the trustees make the appointment within two years of the death of the first spouse, then the appointment will be read back into the will under s144. It would then be taxed as if it was an immediate post death interest with the consequence that the assets in the trust would be subject to IHT on the death of the surviving spouse. If the appointment is made more than two years after death, the surviving spouse can live in the house, and when the surviving spouse dies, the house will not be part of the surviving spouse's estate for IHT purposes.

As with all these ideas, there are disadvantages. The first disadvantage is that if house prices increase, there is a possibility of a ten-yearly or principal charge to IHT. This is of course only a problem if house prices increase, and IHT will probably only be payable on the value over and above the NRB for the tax year when the 10th anniversary falls. In addition, the rate of IHT is very low—6%. This compares very favourably with the rate of IHT which would have been payable if the surviving spouse had an interest in possession in the house.
The second disadvantage is that when the surviving spouse dies, there will not be any free uplift to market value. There may also be a problem with private residence exemption as far as the trustees are concerned if the house is sold; this issue was considered above.

The author considers that the real difficulty posed by Phizackerley is to know how far HMRC will go in alleging gifts as in many marriages there will have been gifts from one spouse to the other. It may be that the spouses will have had a joint bank or building society account, and paid all their earnings into that account. If the surviving spouse has earned more than the other, will HMRC seek to invoke the artificial debt rules if the one who has earned more is the one who survives? Will HMRC seek to invoke the rules if the surviving spouse has inherited assets from the estates of parents, and used them to pay off the mortgage on the matrimonial home?

For a discussion of whether the surviving spouse should be one of the executors, please see *(g)* below.

(f) The loan should not become statute barred. This means that every six years the surviving spouse should acknowledge that the loan is still outstanding—or every twelve years if the IOU or charge is under seal. However, it may be that time does not begin to run against the trustees until there is a demand for repayment (see Limitation Act 1980 s 6) and if the surviving spouse is one of the trustees the surviving spouse or his or her estate may not be allowed to take this point.

(g) It may be that the surviving spouse should not be the sole trustee. This is because you cannot contract with yourself. However, if there are other trustees, this is not a problem.

If the surviving spouse has made gifts to the first spouse to die, and it is proposed to impose a charge, it is probably best if the surviving spouse is not one of the trustees or personal representatives who create the charge. This is to avoid any danger that HMRC might argue that s 103 has been triggered. On the other hand, if the surviving spouse is one of the executors or trustees, it could be argued that the surviving spouse is not imposing the charge himself or herself; instead it is the executors or trustees collectively who are imposing the charge.

In order to avoid the question of whether someone can create an interest in favour of himself, the trustees of the NRB discretionary trust and the residue should not be exactly the same. At least one trustee should be different.

(h) Some assets must be put into the trust. It seems that HMRC may object if nothing is put into the trust other than the IOU or charge. The trustees must therefore hold some assets other than the IOU or charge. It is probably prudent to inject into the discretionary trust as much as the surviving spouse can afford to inject; it is not necessarily lost to the surviving spouse as the trustees can pay it out if necessary.

Another reason for putting assets into the trust is to fund administration expenses, and the payment of any ten-yearly charge to IHT. If the trustees only have an IOU or a charge, then how do they pay the cost of administering the trust, or a ten-yearly charge? It is much simpler if they have some other assets in the trust, and can use them to pay the administration expenses or ten-yearly charge.

In addition, these trusts must work so far as the trustees hold cash or other assets. This point has perhaps become more important since Phizackerly.

(i) If the deceased leaves property qualifying for either agricultural property relief or business property relief, and leaves this type of will, the value of that property may be attributed to both the NRB legacy and the residue. This will happen if the legacy is stated to be whatever can be given free of inheritance tax.

So if a testator has assets which could qualify for agricultural property relief or business property relief, then the will should make it clear whether or not that property is to be included in the legacy to the trustees of the discretionary trust.

(j) What is the position if the matrimonial home is mortgaged?

Presumably any charge can only be for the value of the equity of redemption.

So if the matrimonial home is worth £500,000, and there is a mortgage of £300,000, any charge could only be for the equity of redemption – £200,000.

(k) What is the position if the estate of the first spouse to die is less than the NRB? It is contentious as to whether it is possible to implement the NRB discretionary trust when the estate of the first spouse to die is less than the NRB.

It is the view of the author that if the combined estates of spouses are only marginally above the NRB, it is not worth bothering with these NRB discretionary trusts unless the clients are concerned about other factors, for example concerns care home fees . However, in case some client does think that it is worthwhile, then perhaps precedents should be modified so that there is some residue left. It may be desirable to limit the NRB legacy to a percentage of the residuary estate with a maximum of the NRB in case the residue does not exceed the NRB or alternatively it may be that the trustees of the NRB discretionary trust will have power to fix the amount of the NRB legacy so that they could determine that the legacy, is for example, 90% of the estate.

(l) It has been suggested that the will should not contain a survivorship clause. This is because IHTA 1984 s 92 provides that where under the terms of a will property is held for any person on condition that he survives another for a specified period of not more than six months, this Act shall apply as if the dispositions taking effect at the end of the period had had effect from the beginning of the period.

Under s 92 it is the beneficiary who receives the gift who must satisfy the survivorship condition. So if there is a will where spouses give everything to each other subject to a survivorship clause not exceeding six months, and the survivor survives for the survivorship period, it is treated as if the gift takes effect from the commencement of the period, from the moment of death of the first spouse. In effect the survivorship clause is ignored, and it is treated as if the surviving spouse had been entitled to the legacy the moment the first spouse died.

If s 92 did not exist, who would be entitled to the gift during the survivorship period? Whoever was entitled to the estate after the surviving spouse would be entitled to the gift to the surviving spouse between the date

> of death and the date when the condition was satisfied. In the traditional type of will, this means the children. When the surviving spouse satisfies the survivorship condition, then it is the children who would be deemed to have made the gift to the surviving spouse if it was not for s 92.

Are the trustees of a NRB discretionary trust the beneficiaries? If it is the trustees of the NRB discretionary trust who are the beneficiaries of the legacy, and if they must satisfy the survivorship condition, there is no problem. So if there is a gift of the NRB legacy to the trustees, and the survivorship clause is that the trustees must survive for 28 days, if they do, there is no problem as s 92 applies, and the gift is effective from the date of death of the first spouse.

However, if the NRB discretionary trust is subject to the surviving spouse surviving for 28 days, or there is no beneficiary of the trust, it is arguable that that gift does not come within s 92 as the NRB legacy is to the trustees. If s 92 does not apply to NRB discretionary trusts, then when the first spouse dies, the legacy would fall into the residuary estate, and either the surviving spouse or the children would be entitled depending on the terms of the residuary gift.

However, when the condition is satisfied, for IHT purposes, the gift would not be read back into the will, so the surviving spouse or children would be deemed to have made a chargeable disposal of the NRB.

Example

Spouse 1 creates an NRB discretionary trust subject to a survivorship clause.The residue is left to the surviving spouse, spouse 2.

The argument is that s 92 does not apply if it is the surviving spouse who must satisfy the survivorship clause and not the trustees, or if there are no beneficiaries. If it is the surviving spouse, the consequence is that when spouse 1 dies, spouse 2 will be entitled to all the assets in the trust. If spouse 2 satisfies the survivorship clause, then the NRB discretionary trust comes into effect. For IHT purposes spouse 2 will be deemed to have made a chargeable disposal and prior to 9 October 2007, the NRB of the first spouse to die would have been lost. For deaths after 9 October 2007, the surviving spouse would be able to make use of the transferable NRB, and if he or she survived for seven years after the deemed disposal, and did not make any other gifts, then double the NRB for the tax year when he or she died would be available.

If it is the children who are entitled to the residuary estate, then the NRB of the first spouse to die will have been preserved. However, if the surviving spouse dies after 9th October 2007, then there will not be any transferable NRB.

CGT

If the trustees sell assets subject to the trust for more than the purchase price, or, if the assets were given to the trustees, for more than the market value at the date of transfer, there is a potential liability to CGT. There will be no deaths to extinguish liability.

If the IOU was linked to the RPI or CPI or expressed as a percentage of the value of the house, then, if it is worth more than what it was issued for, on the death of the surviving spouse there may be a liability to CGT or income tax (see below). It should be noted that views differ as to whether there is such a liability.

Income tax

If the trustees accept an IOU from the surviving spouse, or impose a charge, and no interest is payable, then there will not be any income on which income tax will be payable.

If there is any income, the trustees will pay income tax at 40% (50% from 6 April 2010), but if the income is paid to a beneficiary who is not a basic or higher rate taxpayer, the beneficiary will be able to recover the tax paid as long as their taxable income does not exceed their personal allowance. A beneficiary who is a basic rate taxpayer will be able to recover the difference between the basic rate and the 40%/50%, as long as the income received from the trust does not mean that they become a higher rate taxpayer. A beneficiary who is already a 50% higher rate taxpayer will not be liable for any more tax, but will not be able to recover any, but a beneficiary who is a 40% taxpayer will presumably be able to recover the difference between 40% and 50% once the 50% rate comes in.

If the surviving spouse is a higher rate taxpayer, and pays the interest out of income taxed at the higher rate, the combined rate of tax will be 80% for the tax year 2009/10. If the surviving spouse is not a higher rate taxpayer, if interest is paid, the combined rate will be 60%. When the 50% rate comes in, presumably the combined rate of income tax could be 100%

If the interest is rolled up, it could be claimed as a debt due from the estate of the surviving spouse. The trustees will then have to pay income tax at 40%/50%, but if the interest is paid to a beneficiary who is a non-taxpayer, or not a higher rate taxpayer, it will be possible to recover at least part of the income tax.

If there is any income, it should not be mandated to the surviving spouse within two years of the death of the first spouse as if it is HMRC may argue that the surviving spouse has an immediate post-death interest.

The IOU could be a relevant discounted security within FA 1996 Sch 13. This applies where the issue price of a security is less than the redemption proceeds.

Example

The IOU is for £300,000, and is linked to the RPI.

It is worth £400,000 on the death of the surviving spouse.

There is a possibility of a charge to income tax under this section on some of the difference between the amount for which the IOU was issued, and the amount it yielded at the end of the day, which will be the responsibility of the trustees of the NRB discretionary trust.

Not everyone agrees that these IOUs are deep discounted securities.

If they are not deep discounted securities, HMRC might seek to charge the increase in value to income tax on the basis that it is interest. It is the payment for the loan, and if it is viewed in that light, then it is subject to income tax.

If the increase in value is not subject to income tax, then there is a risk that HMRC may seek to charge the increase in value to CGT. Section 251 of the Taxation of Chargeable Gains Act 1992 appears to exempt debts from CGT. However, it could be argued that the IOU or charge is a piece of property which has gone up in value and that when it is repaid that the increase in value is subject to CGT. If the increase in value is not that great, there should be no problem as it should be covered by the annual exemption available to trustees.

Stamp duty land tax

Is the IOU subject to SDLT?

Is any charge subject to SDLT?

This has been a vexed question, and opinions have differed.

However, the HMRC produced a statement saying in effect that SDLT is payable in various circumstances. Is this correct?

SDLT charges a land transaction. A land transaction is any acquisition of a chargeable interest. What is a chargeable interest? It is an estate, interest, right or power in or over land in the UK.

With the NRB discretionary trust scheme coupled with the power to accept an IOU, it is arguable that what is happening is that the executors are in effect selling the assets of the first spouse to die to the survivor in return for an IOU. As the assets of the first spouse to die will include the interest of that spouse in the matrimonial home, it is arguable that there is a land transaction. This view is not universally held.

The HMRC statement provides that SDLT is chargeable in the following circumstances:

> Where the PRs accept a promise by the surviving spouse to pay, and transfer the house to the surviving spouse in consideration of that promise.
>
> The trustees of the NRB legacy accept a promise to pay in satisfaction of the legacy, and land is transferred to the surviving spouse in consideration of the spouse liability on the promise.
>
> Where the PRs transfer land to the surviving spouse, and the spouse charges the property with the amount of the legacy.
>
> However, no SDLT is payable if the PRs charge the land with the NRB legacy, and the PRs and the trustees of the NRB legacy agree that there is no personal liability on the owner of the land for the time being.

How does this work? It is possible to have charge over land where there is no personal liability on anyone.

On what consideration do you pay the SDLT? It is the amount for which the IOU or charge is given.

It has been suggested earlier that an obligation should be imposed on the surviving spouse to pay interest at a commercial rate in order to prevent HMRC arguing that there was an interest in possession. Alternatively, you can link the IOU to the CPI or RPI, or express it as a proportion of the value of the house. This may not be a point open to HMRC. However, it may be wise to assume that it could still be a point open to HMRC. It would be rather odd to have a charge which states that there is no personal liability on the surviving spouse, and then goes on to impose a liability to pay interest at a commercial rate. If the trustees and the personal representatives agree to impose a charge and state that there is to be no personal liability on the surviving spouse, and then the surviving spouse agrees in a separate document to pay interest at a commercial rate, HMRC might argue that there was a land transaction. The promise to pay interest was given in return for the transfer of the former matrimonial home to the surviving spouse, and therefore there is a land transaction.

Alternatively, the personal representatives and trustees of the NRB discretionary trust could agree that the charge was to be linked to the RPI or CPI, or expressed as a proportion of the value of the house. In the view of the author, it is best to link it to the RPI or CPI. The reasons for this are that it should avoid any argument by HMRC that there is an interest in possession in the IOU. In addition, there should not be a major problem, if any, with ten yearly charges. And further if there is a CGT liability if the charge increases in value, it may be covered by the annual exemption for CGT purposes.

Another issue is that the value of the half share in the house may be less than the NRB. In that situation there will have to be a charge for the value of the half share imposed by the executors and trustees with no liability on the surviving spouse, and the surviving spouse will then have to give an IOU for the balance of the NRB.

Example

Spouse 1 and spouse 2 execute NRB discretionary trust wills.

Spouse 1 dies.

A half share in matrimonial home is worth £150,000.

The executors of spouse 1 can create a charge for the amount of the value of the half share over the half share. The charge must state that there is no personal liability on spouse 2 to repay the charge. If spouse 2 then gives an IOU for the balance of the NRB it is arguable that there is no land transaction as the IOU is being given in return for the transfer to spouse 2 of spouse 1's cash and investments. As long as the IOU is drafted in these terms, that it is being given in return for the transfer of the non house assets, then hopefully no SDLT will be payable.

What is the value of spouse 2's share? Is it a mathematical half of the full market value, or should there be a discount because the surviving spouse is entitled to remain in occupation? This is a matter for the valuers, but there should be some discount off the full market value.

Another issue is whether the executors and trustees of the NRB discretionary trust should be the same people. If they are, can they impose a charge in their favour? The argument that they cannot do so is because you cannot enter into a contract with yourself. However, what is happening is that the executors/trustees are imposing a charge on the half share in the matrimonial home which they are going to vest in the surviving spouse. It is not as if the executors and trustees are entering into a contract. In the circumstances it is probably best if the executors and trustees are not exactly the same—either appoint an additional trustee of the NRB discretionary trust, or one trustee can retire.

It has been suggested that you can avoid SDLT by creating the NRB discretionary trust in a deed of variation. It is certainly true that deeds of variation do not involve any SDLT liability. The SDLT exemption only applies if there is no consideration in money or money's worth. If the correct analysis of these NRB discretionary trusts is that it is a sale of the interest of the first spouse to die in return for the IOU, in the view of the author there is consideration.

Non-tax disadvantages

The surviving spouse is at the mercy of the trustees. This may or may not be a big disadvantage. If the children are the trustees of the NRB discretionary trust, there is no guarantee that they will agree to accept an IOU, or impose charge. They might insist on the cash. This could force the surviving spouse to sell the house.

Trustees must also act in the best interests of all the beneficiaries—is it in the best interests of all the beneficiaries to accept an IOU or charge?

Trustees must also take advice about investments—what is the position if the advice is not to take an IOU or impose a charge, but instead to insist on cash, and invest it either directly or indirectly on the stock exchange? It may be very difficult to find anyone who is prepared to advise about whether or not to take an IOU or impose a charge.

Under the Trustee Act 2000, trustees are under a duty to review investments and take advice about them periodically, and they should meet regularly to consider whether they ought to call in the IOU, or enforce the charge, and invest the cash.
If they have accepted an IOU, and it is not supported by a charge, they may also need to consider whether there are going to be sufficient assets in the estate of the surviving spouse to satisfy the NRB legacy. If there are insufficient assets, this may eliminate any IHT charge, but could be a breach of trust as far as other beneficiaries are concerned.

There may also be problems in respect of a surviving spouse who is also an executor or trustee, but who will not co-operate with the other trustees; it may be that there would have to be an application to the court to remove such a trustee.
The distribution of the proceeds of the IOU on the death of the surviving spouse could also cause difficulties. It is not every family that will be able to agree on an equal division of the proceeds, and there may be some situations when it will be desirable to prolong the trust, for example if one child is mentally incapable.

Existing nil rate band discretionary trust

Many clients will have already executed NRB discretionary trust wills. It is not necessary to write to these clients suggesting that they make new wills as a NRB discretionary trusts can be terminated easily within two years of the death of the first spouse. Indeed, there may be good reasons for implementing these trusts, for example, concerns about care home fees.

If an appointment is made from a discretionary trust usually more than three months after but within two years of death, the deceased is treated as having disposed of the property in accordance with the appointment for IHT but not CGT purposes. The effect of this rule is that if the trustees terminate the discretionary trust more than three months after death but within two years, the deceased is treated as if he had disposed of the property in accordance with whatever the trustee have done. Thus if the termination is in favour of the spouse, the deceased will be treated as having disposed of his property to the spouse for IHT purposes, and spouse exemption will apply, provided the spouse is domiciled in this country. Then on the death of the surviving spouse, double the NRB available on her death can be offset against the estate of the survivor.

However, there is no special treatment for CGT.

There is no problem if the assets subject to the discretionary trust are vested in the trustees, and they then make an appointment. What is the position if the executors/trustees make an appointment before the assets have been vested in them as trustees?

HMRC may argue that the appointment is invalid because it has been made by the executors and not by the trustees. It is believed that the Revenue do not take this point now, but it is possible to include a clause in the will saying that executors can exercise the powers of trustees even though assets may still be vested in them in their capacity as executors.

The CGT position depends on whether the appointment is made before or after the completion of the administration. It may also vary on whether it is an absolute appointment or the creation of a new trust.

Assuming that it is an absolute appointment, if it is made before the completion of the administration of the estate, the position is not clear. When a person dies, the beneficiaries or trustees under the will or intestacy do not have a right to any of the assets. The estate may prove to be insolvent, and all the assets go to the creditors of the deceased so that the beneficiaries or trustees receive nothing. All that the beneficiaries or trustees have is a right to have the assets administered – a chose in action. This chose in action has a nil base cost, but if the estate is solvent, a market value close to the value of the assets the subject of the appointment. Any appoint-

-ment would be a deemed disposal at market value of that chose in action by the trustees, but as its base cost is nil, there could be a massive liability for CGT. When the administration of the estate is completed, then the PRs will vest the assets in the beneficiaries. The normal rule then applies – the beneficiaries will be deemed to acquire the assets at market value as at the date of death. They are beneficiaries under the will.

On the other hand, if the administration has been completed the position is clear. The personal representatives vest assets in trustees – the trustees deemed to acquire assets at market value as at the date of death. If the trustees appoint an asset, shares or land, then the beneficiary will become absolutely entitled to those assets. This means that the trustees will be deemed to dispose of the assets at market value.

Example

A dies having appointed Y and Z as his executors and trustees.

The will gives theshares in Q Plc to be held on discretionary trusts by the trustees.

The shares were worth £400,000 at date of death.

They are now worth £500,000.

So if the administration of the estate is not complete, the trustees will be deemed to dispose of a chose in action at market value, £500,000. The base cost will be nil, so the trustees will have incurred a large CGT liability. When the PRs transfer the assets to the beneficiary, the beneficiary will be deemed to acquire them at market value as at the date of death.

If the administration is complete, then the trustees will be deemed to dispose of the appointed assets at market value. So the trustees will be deemed to have acquired them at market value as at the date of death – £400,000. If the shares are now worth £500,000, and the trustees make an appointment, there will be a deemed disposal of the shares for £500,000. So the trustees will be liable for CGT on the gain of £100,000 less the amount of any available reliefs or exemptions.

Note that HMRC may not take this point, and will treat the personal representatives as disposing of the assets directly to those in whose favour the appointment is made as long as the administration of the estate has not been completed - see CG31432 – CG31433.

Usually the trustees of the NRB discretionary trust will also be the executors. It is probably best if they postpone making an appointment until they have completed the administration of the estate and become trustees, or have appropriated assets to themselves as trustees.

They should also ensure that they have the IOU from the surviving spouse, backed up by a charge, or a charge.

It is probably a good idea for the executors if they are also the trustees to meet and resolve that the administration of the estate has been completed, and may be execute a memorandum of appropriation in their favour as trustees.