



Why we need to use both Discretionary Trusts and Interest in Possession Trusts

Relevant to married couples and civil partners with estates in excess of the tax-free amount; the Nil Rate Band (NRB) and the Residence Nil Rate Band (RNRB) if it applies. This sheet will refer to the tax-free amount when referring to both of these possible outcomes.

Interest in Possession Trust (IIP)

There is no Inheritance Tax (IHT) on gifts in life or on death between married couples and civil partners (other than limitations between non-domiciled spouses). This tax-exempt gift between spouses is known as the spousal exemption.

This means on death, if you leave all your assets to your spouse, or more crucially, those above the tax free amount, spousal exemption applies. So there is no IHT on first death.

If you leave assets above the tax free amount to a qualifying IIP (Immediate Post Death Interest for IHT), the spouse is the life tenant (current beneficiary), sometimes also referred to as having the right to income, there is also no IHT on 1st death. This is also treated as a gift between spouses for tax purposes, so there is no IHT on first death, just as you'd expect between married couples.

If the IIP was not used and all assets were left to a discretionary trust (or trusts) and the estate is in excess of the tax free amount, this is not treated as a gift between spouses for IHT, as the spouse has no absolute rights to benefit (even though they can and usually will benefit - but at the trustees discretion).

Hence there is no spousal exemption in this scenario and thus if this planning was in place it would create IHT on any excess estate over the tax free amount on first death, unnecessarily and would lead to disappointed beneficiaries.

Discretionary Trust

Between married couples we also use the discretionary trust for the tax free amount, with any excess directed to the IIP where the estate of a married couple is in excess of the tax free amount.

So why use both types of trust, when some providers only use IIP for the whole estate?

We use the discretionary trust as well as the IIP, partly in case legislation is ever changed that might remove the transferable tax free amount between spouses. The use of a discretionary trust as well as IIP ensures the NRB is used on first death and not lost.

There is also now the RNRB to consider if it applies, so the use of a discretionary trust as well as IIP is even more vital now. The RNRB legislation states that to qualify for the RNRB, the value must pass to lineal descendants, either absolutely or by giving those persons a qualifying IIP for that value (which means they are entitled to it for tax purposes, so it qualifies).

Establishing a discretionary trust ensures that the RNRB can still be utilised, even when the value has not been given absolutely to lineal descendants. A discretionary trust allows an appointment from the trust, using s144 IHTA 1984, within 2 years of the death. This ability does not exist on an IIP trust. We can thus appoint the value absolutely to a lineal descendant, or create an IIP in favour of the qualifying lineal descendant beneficiary(ies), or allow the value to transfer between spouses, if appropriate. Although the appointment of IIP means that the value of the RNRB then aggregates with the estates of the lineal descendants for their own IHT liability, there is further work we can do to mitigate that liability as well.

Relying on planning that hinges on transfers between spouses, which is the effect that leaving the whole estate on IIP/FLIT/life Interest has, can lead to the loss of the RNRB on larger estates, as it begins to taper after 2 mil (so the surviving spouse may have reduced or no RNRB). Hence the flexibility of our planning structure allows an appropriate decision to be made on 1st death as to whether it's better to allow the allowance to transfer or not.

By using discretionary trusts as well as IIP therefore, the RNRB can be secured but the assets remain protected as much as possible against all the third party threats such as a beneficiary's divorce, creditor claims, care fees and generational IHT.

Our discretionary trusts (used for death planning) specifically utilise the RNRB, as even if the trustees don't take the required action within 2 years under s144, our trusts have a default clause ensuring the lineal descendants do benefit, via an IIP. Therefore we always need to use both a discretionary trust and an IIP for married couples and civil partners with estates in excess of the NRB (and it is wise to allow room for growth on estates nearing that value), as no one wants to pay tax before it is absolutely necessary to do so.

Naturally on second death, if the combined estate is in excess of 2xNRB/RNRB, there would be IHT due then. Only lifetime planning can address that issue.