PEMBERTON GREENISH

Tax Planning using the Matrimonial Home

Will trusts and IOUs

The recent case of Phizackerley v Revenue and Customs 2007 has focused attention on the often tricky area of Inheritance Tax planning using Nil Rate Band Trusts and the matrimonial home.

Common Tax Planning through Wills

It is increasingly common for a husband and wife to make wills establishing a trust of the Inheritance Tax Nil Rate Band (the name given to the £300,000 allowance). This is to ensure the Nil Rate Band of the first to die is used and not wasted: when the first dies £300,000 goes in to the trust which is for the benefit of the family as a whole. The trust sits outside estate of the survivor and so escapes tax on his/her death.

This only saves tax if when the first dies, he has assets in his sole name which he can leave to such a trust. As it cannot be known which of the husband and wife will die first, it is important to ensure an even distribution of assets (or a distribution which leaves both with at least £300,000). Often this involves a transfer of assets (most commonly an interest in the matrimonial home) from one to the other. It is where there has been such a transfer that problems can arise.

There are two relevant issues raised in Phizackerley. The first concerns the Nil Rate Band Trust:

Tax planning with the Matrimonial Home

The Revenue does not accept that such trusts are effective to avoid Inheritance Tax if the asset of the trust is a share in the matrimonial home: part of the house is then owned by the survivor and the rest owned by the trust. In practical terms (the Revenue argue) the survivor has an exclusive right to occupy the whole house and the trustees can do nothing to control the

trust's share, or to let any other family members use it. This right to occupy makes the trust's share taxable on the survivor's death.

To avoid this trustees often accept a promise (or IOU) from the survivor (say the wife) to pay them when she can. The IOU is a valuable asset for the trustees, and more importantly a debt for the wife. Since debts reduce a person's taxable estate they also reduce the Inheritance Tax due on death - by 40% of the debt's value. A debt of £300,000 means £120,000 less tax. It doesn't matter that the wife owes the debt to a trust of which she is a potential beneficiary. And it doesn't matter that the trust is her husband's will trust, unless the second issue is in point.

The second issue relates to what was done by way of transfer of assets before the first death:-

Gifts with Loans Back

Not all debts reduce Inheritance Tax. Specifically a debt owed to a person to whom the deceased had previously transferred assets does not. For example, this is to stop a father with an estate of £600,000 giving £300,000 to his son, and his son then lending the £300,000 back to the father. The father is back in almost exactly the same position he was prior to the gift apart from the fact that he has acquired a £300,000 debt. If such a debt was allowed the family would have conjured up a tax saving of £120,000 apparently from nowhere. So the debt is ignored, and the whole £600,000 is taxed on the father's death.

The problem highlighted in Phizackerley

To see how the two rules work together, assume that the matrimonial home is in the husband's name; he then transfers half to his wife to balance their estates; his wife dies. His wife's will contains a Nil Rate Band trust. Her will trustees accept an IOU from the husband and her share of the house is then transferred to him. The IOU is a valid debt owed by the husband to the trustees of the wife's will trust, and so should be deductible from his estate on his death. However because the husband had previously given assets to his wife, and she (or more accurately her estate) lends them back to her husband, the debt (the IOU) would be ignored. When the husband dies the whole house is taxed on his death, with no deduction for the IOU and no hope for Inheritance Tax saving.

The facts in Phizackerley were almost exactly as described here apart from the fact that the house was bought in joint names, but only using the husband's money. It was at the moment of purchase that the husband was treated as transferring assets (a half share in the house) to his wife.

It is not always a problem

For there to be a problem there must be a number of factors present:

- A transfer of assets of any type (i.e. not just a share in the matrimonial home) at any time in the past
- Wills containing Nil Rate Band Trusts
- In both estates, insufficient assets to satisfy the Nil Rate Band trust without recourse to the matrimonial home.

There will not be a problem if the person who made the transfer dies first.

There is a solution

For those not prepared to gamble on who will survive whom there is still a solution, although it may seem to complicate still further what is already complicated enough.

If the wills each contain two trusts rather than one, the first being the discretionary trust of the Nil Rate Band and the second being a trust for the surviving wife of the rest of the husband's estate, then instead of the wife (to whom assets have previously been transferred) owing money to the trustees of the husband's Nil Rate Band trust, it is the trustees of the second trust who owe the money. The husband had not previously transferred assets to the trustees of that second trust and so the loan can be allowed.

Is it worth it?

For some, wills of that complexity may be a step too far. However they are worth considering given the tax that they can save. With the Nil Rate Band at £300,000 and set to increase, the tax saving is at least £120,000.

If you are concerned about whether and how this might impact on your own situation then we would be happy to review this with you.

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