When it comes to estate planning, will drafting is too important to be an afterthought

Estate planning and will drafting should go hand in hand. In this tax planning insight, Jessica Franks explains why wills need to be revisited after making a significant investment decision, such as investing in assets that qualify for inheritance tax reliefs.

Most clients are likely to revisit their will after making significant investment decisions, to make sure it continues to reflect their current assets and wishes for their beneficiaries. It is also typical to make sure that the will is maximising the benefit from any relevant reliefs from inheritance tax.

There's no 'best' way to draft a will, as it depends on the client's situation and what they are looking to achieve. Therefore, we always recommend clients seek the advice of an experienced professional capable of taking often complicated rules into account. However, as a provider of investments that qualify for Business Property Relief (BPR), we wanted to highlight some considerations that are specific to qualifying investments.

This note might be useful to you if:

- You have clients with estates likely to exceed £2 million, which include investments that qualify for BPR or Agricultural Property Relief (APR); or
- You have clients who might want to make exempt gifts (such as to their spouse or charity) and own APR or BPR-qualifying investments.

Which reliefs might merit further attention when drafting a will?

Relevant reliefs can include the following:

1. The **nil-rate band**, which has been held at £325,000 per person since 2009. Also, following the death of the first spouse, any unused portion of the nil-rate band can be transferred to the surviving partner.
2. The **residential nil-rate band (RNRB)**, is an additional allowance that can be claimed on top of the nil-rate band, provided the criteria for eligibility is met. You can work out a client's inheritance tax liability by using our RNRB calculator (octopusinvestments.com/rnrbcalculator).
3. **Spousal exemption** – transfers between married couples and civil partners are not subject to inheritance tax.
4. **APR** – a relief from inheritance tax which can be claimed on the value of agricultural property (farmland, woodland, farmhouses and cottages).
5. **BPR** is also considered a relevant relief, and is available on qualifying assets and shares that are held when someone dies, provided they have been held for at least two years at that time.
6. Where **significant gifts** are left to charity, a reduced rate of inheritance tax (from 40% to 36%) is applied. The charitable legacy itself is not subject to inheritance tax.

Considering the residential nil-rate band

The RNRB started at £100,000 per person and increases annually by £25,000 every April until 2020, when it reaches £175,000. After that it will increase each year in line with inflation (measured by the Consumer Price Index). The RNRB comes with a tapering restriction, and is reduced by £1 for every £2 by which the deceased's net estate exceeds the 'taper threshold' of £2 million. This means that the maximum value of an estate that can benefit to any degree from the RNRB will be £2.35 million by April 2020 (£2.7 million for a surviving spouse).

Although investments that qualify for BPR will be taxed at a 0% rate of inheritance tax if they have been held for at least two years when the owner passes away, they will still form part of the value of the estate for the taper threshold purpose. The same is true of APR-qualifying assets and exempt gifts, such as those passed to a spouse or left to charity.

It is worth remembering that the taper threshold might be relevant at both the time of the first spouse's death, and the second. If the estate of the first spouse is valued at more than £2 million, the percentage of transferrable residence nil-rate band available to carry forward would be reduced accordingly. When considering whether a client's estate exceeds the £2 million taper threshold after which the RNRB is scaled back, it is worth noting that all assets owned at death need to be included.

Will drafting can affect the amount of inheritance relief available

Broadly speaking, gifts bequeathed in a will fall into one of three categories:

- As the name suggests, a specific gift is an item described precisely in a will, so the executors of the will know the exact intention of the deceased. The clearest examples of a specific gift would be an item of jewellery, a property or an exact sum of money.
- Conversely, a non-specific gift is a general gift that doesn't refer explicitly to a particular item – for example the deceased could leave a beneficiary 'all their personal possessions'.
- Finally, residuary gifts would be leaving a beneficiary everything else left in the estate, or a group of beneficiaries each a portion of everything else left in the estate, after the deduction of all debts, taxes and outstanding bills.

Leaving only residuary gifts

Your client might want to leave a will that contains no specific gifts and so intends to leave their entire estate as residue. Depending on their personal circumstances, and whether they own APR or BPR-qualifying assets, they could be placing their estate in a position where the inheritance tax saving realised from reliefs is less than expected.

Take the example of a client who wishes to leave 50% of their estate to their spouse, 40% to their children, and 10% to charity. Any BPR-qualifying assets would be attributed to the transfer of the estate as a whole, so in this example 60% of the assets that qualify for BPR or APR would be attributed to the exempt legacies (charity and spousal gifts), effectively 'wasting' some BPR against transfers which would not be subject to inheritance tax in any event.

If the spouse also in fact takes possession of 50% of the qualifying assets on appropriation by the executors, this may not be more costly than alternative arrangement. This is because – provided the assets are still held when the second death occurs – an inheritance tax saving will be realised later on. However, the allocation to the charitable gift will represent an absolute additional cost on the occasion of the first death.

Leaving specific gifts

The Inheritance Tax Act 1984 contains rules at section 39A that determine how much inheritance tax relief is available where:

- the estate contains assets that qualify for BPR and APR; and
- the will states that gifts are made to beneficiaries who are exempt from inheritance tax (such as a surviving spouse or a charity); and
- assets that qualify for BPR or APR are left as part of the residue of the estate.

For clients who own BPR or APR-qualifying assets, and who are either survived by a spouse and/or leaving a gift to charity in their will, it can be beneficial to consider how they intend to pass these assets on to their beneficiaries. Leaving qualifying assets as part of the residue of an estate which is also partially exempt from inheritance tax, can result in a higher tax bill than might be expected.

Where a client wants to make gifts to exempt beneficiaries in their will, the simplest way to ensure there's no apportionment of relief may be for the client to make a specific gift of their BRP or APR-qualifying assets.

These rules can be complicated where they apply. In Table 1 we contrast two estate planning scenarios where will drafting could impact the amount of inheritance tax payable on the estate. In both scenarios, the client's estate includes a house worth £1 million, owned equally as tenants in common with their spouse. The client also owns £300,000 of BPR-qualifying investments and £400,000 of cash, shares and chattels.

For HMRC's guidance in relation to these rules, use this link: **https://www.gov.uk/hmrc-internal-manuals/inheritance-tax-manual/ihtm26101**

Table 1: how will drafting can reduce inheritance tax liabilities

Scenario A: Client wishes to leave specific exempt gifts, with their BPR qualifying assets as part of the residue of their estate to their child.

The will specifies that the share of the house will pass as a specific gift to their spouse and will bear its own tax. The residue of the estate (£700,000 including £300,000 BPR qualifying assets) will pass to their child as residue.

As the BPR-qualifying investment is not left as a specific gift and the will contains a specific exempt gift (to a surviving spouse), a fraction needs to be calculated and applied to the exempt gifts:

Fraction: chargeable assets/total assets
900,000/1,200,000 = 0.75
Applied to the gift to spouse:

£500,000 x 75% = £375,000

Here's the inheritance tax calculation for the estate:

Total estate value	£1,200,000
Less BPR-qualifying assets	(£300,000)
Chargeable assets	£900,000
Less exempt gifts to spouse £500,000 x75%	(£375,000)
Less: nil-rate band	(£325,000)
Inheritance tax at 40% on	£200,000
Inheritance tax due	**£80,000**

Summary: where a client's will provides for specific exempt gifts (such as to their spouse or to charity), and their estate also includes assets that qualify for BPR or APR to be left as residue, then the effective rate of inheritance tax applied to the exempt gifts might be greater than 0%.

Scenario B: Client wishes to leave their BPR qualifying assets as a specific gift to their child.

The will specifies that the share of the house will pass as a specific gift to their spouse. The client's will also names the £300,000 BPR-qualifying investment as a specific gift to their child. All legacies bear their own tax. The residue of the estate (£400,000 of cash, shares and chattels) passes to the child.

As the BPR-qualifying investment is left as a specific gift, even though the will contains a specific exempt gift (to a surviving spouse), there is no need to apply any apportionment to the relief.

Here's the inheritance tax calculation for the estate:

Total estate value	£1,200,000
Less BPR-qualifying assets	(£300,000)
Chargeable assets	£900,000
Less exempt gifts to spouse £500,000 x100%	(£500,000)
Less: nil-rate band	(£325,000)
Inheritance tax at 40% on	£75,000
Inheritance tax due	**£30,000**

Summary: choosing to leave BPR or APR qualifying assets as a specific gift saves inheritance tax of £50,000 compared to Scenario A. This is because no apportionment of relief across the specific exempt legacy is required.

It's also worth noting that these complicated rules will not change the tax liability in cases where the client's partner has died first, and where they as the surviving spouse plan to leave their estate to children and grandchildren without leaving any charitable donations.

Assets passing outside of a will

Clients can, of course, also pass on assets outside of their will (sometimes known as the 'General Component'), for example, through jointly-owned assets that pass automatically (the 'Survivorship Component'), or through trust assets that become taxable as a result of the client's death (the 'Settled Component'). The rules of interaction contained in section 39A relate to assets that pass under the same element (or 'component') for example, as between all property passing by will under the General Component.

Further points

As well as keeping the above rules in mind when will drafting, there's the need to consider 'grossing up' where the estate includes gifts that are to be made free of tax and where all – or part – of the residue will pass to an exempt beneficiary. However, the effects of grossing up can lead to unexpected results, especially when accompanied by the rules that govern the attribution of BPR and APR. Specialist assistance should therefore always be sought where needed.

A Reminder about BPR qualifying investments

BPR-qualifying investments can be an attractive option for a client who is considering estate planning. They enable an investor to retain ownership of their wealth for the rest of their life whilst qualifying for relief from inheritance tax, provided the investment has been held for at least two years when the investor passes away. To qualify for BPR, an investment must be made into the shares of unlisted or AIM-listed trading companies, therefore capital invested is at risk. The value of an investment, and any income from it, can fall as well as rise. Investors may not get back the full amount they invest. The value of tax relief will depend on each investor's individual circumstances and could change in the future. The availability of tax relief depends on the companies invested in maintaining their BPR-qualifying status.

Conclusion

Will drafting is a highly specialist skill set, the value of which only increases when a family has more complicated financial arrangements. As such, it should always form an integral part of estate planning for high net worth clients. Seeking professional advice, and ensuring that the will accurately records the person's wishes and intentions, is vital for such an important document. When it comes to investments that qualify for reliefs such as BPR and APR, it is important that the will provisions are given due consideration so that the available reliefs are not wasted, thereby reducing the amount of relief that can be claimed.

For some clients, if investments that qualify for BPR or APR are not left as specific legacies, the estate may not receive the inheritance tax saving the investor is expecting. However, if all BPR or APR-qualifying assets are left as specific gifts, the allocation rules do not apply, therefore leaving a qualifying asset as a specific gift might be beneficial, although this will depend on your client's specific circumstances and how they wish their estate to be distributed.

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