

## CHAPTER 12

### INTEREST IN POSSESSION TRUSTS - IHT ISSUES

#### 12.1 Definitions

The term "interest in possession" has no statutory definition. Following the case of *Pearson v CIR*, it is widely recognised that the term interest in possession broadly means a "**present right to present enjoyment of income**". This means that if a beneficiary, at this moment in time, has power to enjoy the income of a trust, he or she will have an interest in possession.

HMRC Press Release 12 February 1976 sets out their understanding of the term "interest in possession". An interest in possession in trust property exists where the person having the interest has an **immediate entitlement to any income** produced by the property in the trust.

IRPR  
12.2.76

If the trustees have a discretion or power to withhold income from that person, such a power will negate the existence of an interest in possession. Therefore if the trustees have a **power to accumulate** income within the trust, **no interest in possession will exist**.

An interest in possession will exist where a beneficiary has a **present right** to enjoy the income of the trust. Therefore if the trustees have **power to remove future income**, this **does not negate** the existence of a current interest in possession.

An **exclusive right to enjoy an asset within a trust**, is also an interest in possession, even if that asset does not produce any income. HMRC Press Release 15 August 1979 states that if trustees permit a beneficiary to **occupy a dwelling house at less than full commercial rent**, this will create an interest in possession. This has inheritance tax implications.

#### 12.2 22 March 2006

Finance Act 2006 made significant changes to the IHT treatment of interest in possession trusts created on or after 22 March 2006. This means that you need to know two sets of rules:

- 1) where the trust was **created before 22 March 2006**; and
- 2) where the trust was **created on or after 22 March 2006**.

### 12.3 Trusts created before 22 March 2006

Interest in possession (IIP) trusts created during the lifetime of the settlor before March 2006 were usually **potentially exempt transfers**. IHT was only chargeable if the settlor died within 7 years of setting up the trust.

[IHTA 1984, s.3A\(1\)](#)

There were a couple of exceptions to this rule;

- 1) where the life tenant was the **spouse** of the settlor, the gift was exempt; &
- 2) where the **settlor himself** was the life tenant, the transfer was ignored for IHT.

The creation of a discretionary trust was a **chargeable lifetime transfer**.

[IHTA 1984, s.2](#)

The lifetime creation of an accumulation and maintenance (A&M) trust was a **potentially exempt transfer**.

[IHTA 1984, s.3A\(1\)](#)

### 12.4 Trusts created on or after 22 March 2006

The creation of an IIP trust during the lifetime of the settlor on or after 22 March 2006 is a **chargeable lifetime transfer**. The creation of a discretionary trust remains a **chargeable lifetime transfer**.

Trusts which would have been A&M trusts under the old rules are now simply discretionary trusts. Therefore the creation of an "A&M type" trust after March 2006 will be a **chargeable lifetime transfer**.

<b>SUMMARY</b>	Before 22 March 2006	On or after 22 March 2006
Interest in possession trust	PET	CLT
A&M / A&M "type" trust	PET	CLT
Discretionary trust	CLT	CLT

## 12.5 “Relevant property” v “Qualifying IIPs”

To understand the inheritance tax treatment of interest in possession trusts, we need to be able to **differentiate between “relevant property” and “qualifying interests in possession”**.

In broad terms, “relevant property” is property which is **not comprised in the estate of a settlor or a beneficiary**. In order to ensure that such assets are not therefore outside the scope of IHT, **relevant property is subject to exit and principal charges**.

Where trust assets are held on “qualifying interest in possession”, such assets **ARE** comprised in the estate of a beneficiary. **Therefore, where a beneficiary is a life tenant of a qualifying interest in possession trust, the trust assets form part of his death estate**.

As “qualifying IIPs” are already within the scope of IHT, **property within a qualifying IIP is not subject to exit and principal charges**.

Finance Act 2006 changed the rules such that not all life tenants of IIP trusts are now treated as having a “qualifying IIP”.

The table below summarises assets which are relevant property and qualifying IIP;

Relevant Property	Qualifying IIP
1) All discretionary trusts; &	1) Trusts for disabled persons; &
2) A&M trusts post 5 April 2008; &	2) All IIP trusts created on death; &
3) Lifetime IIP trusts created on or after 22 March 2006	3) Lifetime IIP trusts created before 22 March 2006

## 12.6 The taxation of a qualifying interest in possession

The term “qualifying interest in possession” is used to describe;

[IHTA 1984, s.59\(1\)](#)

- 1) assets in a trust for a **disabled person**;
- 2) assets in an **IIP trust created on death**; &
- 3) assets in a **lifetime IIP trust created before 22 March 2006**.

Assets settled on “qualifying interest in possession” trusts **are treated as being part of the estate of the beneficiary** with the interest in possession (the life tenant).

[IHTA 1984, s.49](#)

Because such assets are taxed in the beneficiary's death estate, **“qualifying IIPs” are not subject to exit and principal charges**.

If an individual dies with a qualifying interest in possession in a trust, the trust assets **will form part of his death estate**. The value of a qualifying IIP must be declared by the Executors on the death estate return (form IHT 400).

If the beneficiary only has an interest in part of the trust fund, the same proportion of the assets in the trust is deemed to form part of his estate.

**Assets held by the deceased in his own right** - personal assets etc - make up his "**free estate**". We value the free estate, deduct any liabilities and then **add the value of a qualifying IIP to the assets in the free estate**. This total amount will be charged to IHT.

	£
Value of free estate	A
Value of "qualifying IIP"	<u>B</u>
Chargeable to IHT	<u>C</u>

In essence, even though the life tenant was **only entitled to the income** of the trust during his lifetime, on his death we pretend that the **capital assets which form the qualifying IIP are part of his estate** for IHT purposes.

#### Illustration 1

Peter died in March 2011 having made no lifetime transfers. Peter left a free estate (personal assets etc) worth £500,000 entirely to his son. Peter was also the life tenant of an IIP trust created in 1995. The assets of the trust were worth £300,000 at Peter's death.

As the trust was created before 22 March 2006, the trust is a "qualifying IIP". The trust assets will therefore form part of Peter's death estate.

The remainderman of the IIP trust is Peter's daughter. This means that on Peter's death, the assets of the trust will pass automatically to his daughter.

The IHT is calculated as follows:

	£
Free estate	500,000
Qualifying IIP	<u>300,000</u>
Total chargeable estate	800,000
Less nil band	<u>(325,000)</u>
Taxable	<u>£475,000</u>
IHT @ 40%	<u>£190,000</u>

Peter's **executors** will only pay IHT on assets forming part of the **free estate**. The tax on the **qualifying IIP** - i.e. the IHT that relates to the assets within the trust - will be paid by the **trustees**.

Therefore once we have calculated the total IHT, we **apportion this between the Executors and the Trustees**, as the tax will be paid by two different people.

Paid by Executors:

$$\frac{500}{800} \times \text{£}190,000 = \underline{\text{£}118,750}$$

Paid by Trustees:

$$\frac{300}{800} \times \text{£}190,000 = \underline{\text{£}71,250}$$

If any quick succession relief is available, either in respect of the free estate or in respect of the trust property, this is **deducted before any apportionment is made**. [IHTA 1984, s.141](#)

As Peter's daughter is the remainderman of the trust, she will be entitled to the assets left in the trust after Peter's death. As the trustees will have to pay IHT of £71,250, they will deduct this from the trust fund before appointing the net assets to the daughter. The daughter will therefore receive

$$\text{£}(300,000 - 71,250) = \underline{\text{£}228,750}$$

### Illustration 2

Contrast the above with the situation where an IIP trust is set up **after 22 March 2006** and the life tenant later dies.

Paul died in March 2011 having made no lifetime transfers. Paul left a free estate of £500,000 to his son. Paul was also the life tenant of a lifetime IIP trust **created in May 2007**. The assets of the trust were worth £300,000 at Paul's death. The remainderman of the IIP trust is Paul's daughter.

The position is different as this lifetime IIP trust was set up **after March 2006**.

In this case, the **assets of the trust are not a qualifying IIP**. Instead the trust assets are "relevant property" and the trust is **treated in the same way as a discretionary trust for IHT**.

The trust assets will **not form part of Paul's estate**, and there will be no aggregation of the trust property with his free estate. When Paul dies in March 2011 and the assets pass to his daughter, an **exit charge** arises on the trust, calculated in the same way as for discretionary trusts.

## 12.7 Reversionary interests

**A reversionary interest in an interest in possession trust is excluded property.** This is the case regardless of whether the trust is a qualifying IIP or not. [IHTA 1984, s.48](#)

Therefore if the remainderman of an IIP trust dies before the life tenant, **no part of the trust is included in the remainderman's estate.**

In this situation (unless stated otherwise in the Will or Trust Deed), the person entitled to the residue of the remainderman's free estate will usually become the new remainderman of the IIP trust.

Similarly, if the remainderman gives away his reversionary interest, this is not a transfer of value for IHT.

## 12.8 SP 10/79

Under SP 10/79, a **right to occupy or enjoy an asset** owned by a trust gives rise to an interest in possession. Therefore if that trust was created before 22 March 2006, the right to enjoy the asset is a "qualifying IIP" and the asset will form part of the estate of the beneficiary who enjoys the asset.

This was demonstrated in the case of *Inland Revenue Commissioners v Lloyds Private Banking (1998)*.

A husband and wife - Mr & Mrs "E" - jointly owned a house as tenants-in-common. Mrs E died and under the terms of her will, her half share in the house passed to a trust for her daughter. The terms of the trust directed that Mr E should be permitted to continue to occupy the house after Mrs E's death, and the trustees could not sell their 50% share of the house whilst he was still alive.

Mr E died in 1993. The question here was "how much of the value of the house should form part of Mr E's death estate for inheritance tax purposes?".

HMRC contended, and the Courts agreed, that Mr E's **right to occupy** the half of the house previously owned by Mrs E was an **interest in possession**. [SP 10/79](#)

As the trust was created before March 2006, Mr E therefore had a qualifying interest in possession.

Therefore, for IHT purposes, the **whole of the house formed part of Mr E's death estate**, half in the free estate and half as qualifying IIP.

### 12.9 IIP trusts created on death (Will trusts)

Where an IIP trust is created on death, the **IHT treatment depends on the identity of the life tenant.**

Where the deceased's **spouse/civil partner has an interest in possession in the trust, the transfer is exempt.** This mirrors the rule that transfers to spouses / civil partners are exempt. Where the settlor is UK domiciled and the spouse / civil partner is non-UK domiciled, the exemption is limited to £55,000.

Where **any other individual has interest in possession, the transfer is chargeable.**

In either case, the **trust assets will be a "qualifying IIP"** and will therefore form part of the estate of the beneficiary with the interest in possession. This is the case for IIP Will Trusts created before or after March 2006.

### 12.10 "Immediate post death interests"

[IHTA 1984,  
s.49A](#)

FA 2006 introduced the concept of an "immediate post-death interest". An immediate post death interest is one where:

- (a) the trust was made by a **will or under the rules of intestacy**; and
- (b) the beneficiary became entitled to the interest in possession on the **death of the settlor**; and
- (c) the trust is **not one for a bereaved minor** nor a disabled person's trust.

The trust will be a "qualifying IIP". There are therefore **no exit or principal charges** as there would be for lifetime IIP trusts created on or after 22 March 2006.

There are practical reasons why a testator might wish to create an IIP trust on death. For example, the testator may **want his spouse or civil partner to benefit** from the assets in his estate (for example to have an income stream) **but may not want to give the assets to that person outright** (for example to guard against assets leaving the family in the event of a re-marriage of the surviving spouse).

The testator can set up an IIP trust in his Will, specifying that the spouse or civil partner has an interest in possession for life, but that on his or her death, the assets in the trust are to pass to the remaindermen (most commonly the children or grandchildren).

For IHT purposes, this transfer will be exempt on death. The IIP for the surviving spouse will also be an "immediate post-death interest" so that the assets are treated as forming part of the surviving spouse's death estate.

*Note:* there was no need for the legislation to have a rule for immediate post death interests before March 2006, as all IIPs were "qualifying" before 2006.

### 12.11 "Transitional serial interests" (TSIs)

Once an interest in possession in a trust has come to an end on or **after 22 March 2006**, if the trust continues the rules applying to trusts created on or after that date will apply.

For example, if a second interest in possession follows the cessation of the first interest in possession (a "successive life interest"), that **second interest in possession will not result in the trust assets being treated as part of the second beneficiary's estate** for IHT (ie, the succeeding interest in possession is not a qualifying IIP). Instead, the second trust will be a relevant property trust and will be subject to exit and principal charges.

However there is a special rule where a "**transitional serial interest**" comes into effect between **22 March 2006 and 5 October 2008**.

[IHTA 1984,  
s.49B](#)

A "transitional serial interest" arises where:

- 1) there was an **interest in possession** in a trust **created before 22 March 2006**;
- 2) that IIP **ceases before 6 October 2008** and is **immediately followed by another interest in possession**; and
- 3) it is **not** an interest for a **disabled person**.

In this case, the **second interest in possession is treated as a "qualifying IIP"**. Therefore the trust assets are in the estate of the second beneficiary rather than being relevant property and being subject to exit and principal charges.

A "transitional serial interest" will also apply where:

[IHTA 1984,  
s.49C](#)

- 1) the life tenant of a pre-2006 trust **dies after 5 October 2008**, and
- 2) a **succeeding interest in possession is taken by the spouse / civil partner**.

In this case the trust assets are treated as a "qualifying IIP" in the estate of the succeeding spouse / civil partner.

### Illustration 3

Jamie is the life tenant of an IIP trust created by his father in 1998.

The terms of the trust are that Jamie will be entitled to income for life with a successive life interest to his sister Michelle on his death. On Michelle's death the trust assets pass to Michelle's son Oliver as remainderman.

Jamie died in May 2010.

The IHT implications are as follows:

- The initial gift to the trust by Jamie's father in 1998 was a PET.
- As this is a pre-2006 IIP trust, the trust is a qualifying IIP.
- On Jamie's death in 2010, the trust assets form part of his death estate.
- The tax attributable to those assets is paid by the trustees.
- Michelle has a successive life interest. This is not an immediate post death interest as she did not become entitled to an IIP on the death of the settlor.
- Michelle's interest is not a transitional serial interest (TSI) as Jamie's IIP did not cease before 6 October 2008. Therefore Michelle does not have a qualifying IIP.
- Instead, the IIP trust with Michelle as life tenant will be treated as a relevant property trust and will be subject to exit and principal charges.

The answer would be different if **Michelle had been Jamie's spouse**. In this case **the TSI rules would apply and Michelle's IIP would be treated as qualifying**. Therefore on Michelle's death, the trust assets would form part of her death estate. There would be no exit or principal charges.

**Example 1**

Ashley died in July 2010 leaving a free estate of £560,000. He had made no lifetime transfers.

His uncle had died in September 2006 leaving an estate worth £300,000 on interest in possession trust for Ashley. IHT of £30,000 was paid by the trustees. The trust assets were valued at £400,000 in July 2010.

**Calculate the IHT payable by Ashley's Executors.**

**Example 2**

Frank created an interest in possession trust for his brother George in May 2004. The trust gave George an entitlement to income for life. Thereafter Frank's daughter Holly will take a successive life interest with capital reversion to Holly's children on her death.

Frank died in September 2008. George died in December 2010.

**Comment on the IHT implications.**

**Answer 1**

	£
Free estate	560,000
Qualifying IIP	<u>400,000</u>
Chargeable	960,000
Less: Nil band at death	<u>(325,000)</u>
Taxable	<u>635,000</u>
IHT @ 40%	254,000
Less QSR:	
£30,000 × 40% × $\frac{270000}{300000}$	<u>(10,800)</u>
	<u>£243,200</u>
Executors pay: $\frac{560000}{960000} \times £243,200 =$	<b>£141,867</b>

**Answer 2**

Frank's initial transfer to the IIP trust in 2004 was a PET.

This PET became chargeable on Frank's death in September 2008. The IHT was payable by the IIP trustees.

George's interest in possession is a "qualifying IIP". On his death in December 2010, the assets in the trust will form part of his death estate and will be aggregated with his free estate. The tax will be apportioned between the Executors and the IIP trustees.

Holly has an IIP from December 2010. Holly's interest is not a "transitional serial interest" as she acquired her interest after October 2008 (and she is not George's spouse).

The IIP for Holly will NOT therefore be qualifying. The trust assets will instead be "relevant property" and will thereafter be subject to exit and principal charges as for discretionary trusts.

An exit charge will apply either if Holly dies or she terminates her life interest and capital passes to her children.