CHAPTER 13

INTEREST IN POSSESSION TRUSTS – FURTHER ASPECTS

13.1 Lifetime cessation of an interest in possession

In certain circumstances, an **interest in possession can come to an end whilst the beneficiary is alive**.

An interest in possession could be terminated under the trust deed. For example, a settlor could set up a trust giving his son a right to income **until the son reaches the age of 30.** Therefore at his 30th birthday, the interest in possession will cease.

Alternatively the beneficiary can bring his interest to an end at any time. For example, the **beneficiary could transfer** the right to income to another person.

The IHT treatment of the lifetime cessation of an IIP **depends on whether the interest in possession was a "qualifying IIP" or "relevant property"**.

a) Lifetime cessation of IIP where "qualifying IIP"

If a qualifying IIP ends during the lifetime of the beneficiary, **the cessation of the IIP is (usually) a PET by the life tenant.** This is because, once the IIP ends, the trust assets are no longer in the beneficiary's estate (they have instead moved to someone else's estate). IHTA 1984, s.52

The only exceptions to this are where;

1) **the qualifying IIP ceases and the assets pass to the beneficiary's spouse** (in which case the **transfer is exempt**); or
2) **the qualifying IIP ceases and the assets pass to the life tenant** (in which case there is no **transfer of value**).

Where the cessation of a qualifying IIP causes a PET, annual exemptions for the current and preceding year will be available (assuming they have not already been used). IHTA 1984, s.57

b) Lifetime cessation of IIP where "relevant property"

This will give rise to an **exit charge** (the value of assets in a relevant property trust reduces, so this triggers an exit charge). IHTA 1984, s.65(1)

Illustration 1

Andrew created an interest in possession trust for his nephew, Bradley, in June 1995. The trust gives Bradley an entitlement to trust income until his 30th birthday. At that point, the capital assets of the trust will pass to Andrew's daughter Charlotte.

Bradley will be 30 on 4 April 2011.

The IHT implications are as follows;

- Andrew's original transfer to the IIP trust was a PET as the trust was set up before March 2006.
- The trust is a "qualifying IIP" and the trust assets would therefore be within Bradley's death estate for IHT.
- When Bradley becomes 30 in 2011, Bradley's interest in possession ceases and the trust capital passes to Charlotte.
- The trust assets will now form part of Charlotte's free estate.
- The cessation of the IIP will be a PET by Bradley.
- The value of the PET will be the value of the trust assets at April 2011 (net of any APR, BPR and available annual exemptions).
- Charlotte will pay IHT in the event of Bradley's death within 7 years (i.e. before April 2018).

Illustration 2

David died in August 2007 leaving his estate on interest in possession trust for his wife, Eunice.

The terms of the trust give Eunice an entitlement to income for life with reversion to their 2 children on Eunice's death. The trust provides for Eunice's interest to terminate on the event of her re-marriage.

Comment on the IHT implications if:

1) **Eunice dies in March 2011; or**

2) **Eunice re-marries in 2012.**

The original transfer to the IIP on David's death was exempt from IHT as the beneficiary with the interest in possession is his spouse.

Eunice's IIP is an "immediate post-death interest". The trust is therefore a "qualifying IIP" and the trust assets form part of Eunice's death estate.

1) Eunice dies in March 2011 – the trust will be a "qualifying IIP" in Eunice's death estate and will be **aggregated with her free estate**. The **tax will be apportioned** between her Executors and the IIP trustees. The children will receive the trust assets (net of the IHT paid).

2) Eunice re-marries in 2012 – her IIP will terminate and the trust assets will pass to the children. **This will be a PET by Eunice** and the children will pay IHT if Eunice dies within 7 years (i.e. before March 2019). There is no exit charge as the assets are not "relevant property".

13.2 Valuing settled property

To value a qualifying IIP for IHT purposes, we apply **normal IHT valuation** rules. Therefore quoted shares are valued using the lower of the "quarter up" or "average of bargains" rule, and other assets are valued at open market value. IHTA 1984, s.160

Where the deceased and the trustees have **similar assets in the free estate and in the qualifying IIP**, these must be **valued on an aggregated basis** (ie, in a similar way to related property). IHTA 1984, s.161

Illustration 3

Mr A has 40% of the shares of XYZ Ltd. Mr A has an interest in possession in a pre-2006 trust (ie, a qualifying IIP), and the trustees hold a 20% holding in XYZ Ltd.

When Mr A dies, we do not simply take the value of a 40% holding of shares in the free estate and a 20% holding of shares in the qualifying IIP. These shares must be aggregated together such that the value of the shares in the free estate is 40/60ths of a 60% holding, and the value of the shares in the trust is the remaining 20/60ths of the 60% holding.

This way HMRC ensures that the full value of a 60% shareholding is charged to IHT without the value being diluted.

Relief under S.176 will be available where **assets valued with other assets** for IHT purposes (e.g. assets in free estate and as qualifying IIP) are sold within 3 years of death for less than the amount originally charged to inheritance tax. IHTA 1984, s.176

13.3 Trusts for disabled persons

IHTA 1984, s.89

There is special IHT treatment for trusts set up for disabled persons.

A disabled person's trust is treated in the **same way as an IIP trust made before 22 March 2006.**

Therefore;

1) the **lifetime creation is a PET** / the creation on death is chargeable transfer; &

2) the trust will be treated as **a "qualifying IIP" such that the trust property falls within the estate of the disabled beneficiary.** The trust will not be subject to exit or principal charges.

The above treatment will only apply to disabled person's trusts within the definition in S.89 IHTA 1984.

Under S.89, the disabled person will NOT actually have an interest in possession in the trust property (ie, the beneficiary will not be entitled to the annual trust income). However at least half of the trust property must be applied for the benefit of the disabled person during his lifetime.

13.4 A&M trusts and qualifying IIPs

Trust assets are only within the rules for "qualifying IIPs" if either;

1) an interest in possession in those assets came into being **before 22 March 2006**; or

2) the interest is an **immediate post death interest**; or

3) the interest is a **transitional serial interest**; or

4) the interest is for the **benefit of a disabled person**.

If none of the above apply, the trust assets are **relevant property and subject to exit and principal charges**.

Accumulation & maintenance (A&M) trusts created before 22 March 2006 were protected from IHT until 6 April 2008. Thereafter such "old" A&M trusts usually come **within the relevant property regime from 6 April 2008** and are then subject to exit and principal charges from that date.

However, where an A&M trust gives a beneficiary an **interest in possession**;

i. if the IIP arose **before 22 March 2006**, that part of the trust is a "qualifying IIP" and **does not fall within the relevant property regime**; and

ii. if the IIP arose **between 22 March 2006 and 5 April 2008**, that part of the trust is NOT a qualifying IIP. Instead the assets will be **relevant property with effect from the date the IIP was acquired** (ie, before 6 April 2008).

iii. if the IIP arose **on or after 6 April 2008**, that part of the trust is NOT a qualifying IIP. Instead the assets will be **relevant property with effect from 6 April 2008**.

Illustration 4

The Mason Family Settlement was created by Ted Mason in January 1996 for his 4 grandchildren;

Alexandra	Born 27 March 1978
Simon	Born 26 June 1984
Victoria	Born 5 November 1985
Suzanne	Born 18 June 1989

The trust gives the beneficiaries the right to an interest in possession in 25% of the trust income at age 21, and a right to the same proportion of the trust capital at age 30.

The IHT position of the trust is as follows;

1) The trust would have been a qualifying A&M settlement with IHT protection under S.71 IHTA 1984. There would have been a PET on creation with no exit and principal charges (until the rule changes in FA 2006). There was therefore no principal charge on the ten-year anniversary of the trust in January 2006.

2) Alexandra acquired an IIP in one-quarter of the fund from her 21st birthday in March 1999. This was a pre-March 2006 IIP and was therefore **a qualifying IIP in her estate**. Alexandra became entitled to her share of the trust capital on her 30th birthday in March 2008. There was **no IHT at this point** as the assets simply moved from qualifying IIP into her free estate, so there was no transfer of value.

3) Simon acquired an IIP in one-quarter of the fund from his 21st birthday in June 2005. This was a pre-March 2006 IIP and is therefore **a qualifying IIP in his estate**. When Simon becomes 30 in June 2014, the assets will move into his free estate. There will be **no IHT charge at this point**. This part of the fund is not relevant property so there will be no exit charge.

4) Victoria acquired an IIP in one-quarter of the fund from her 21st birthday in November 2006. This was a post-March 2006 IIP and is therefore **NOT a qualifying IIP**. Victoria's share of the fund is therefore **relevant property** and will be subject to exit and principal charges. Therefore an exit charge will arise when Victoria becomes 30 in November 2015.

   Victoria's share of the trust fund **became relevant property with effect from 5 November 2006** (not from 6 April 2008). Therefore when counting the number of completed quarters for the purposes of the exit charge, we use 5 November 2006 as the date the trust assets became relevant property.

5) Suzanne acquired an IIP in one-quarter of the original fund on her 21st birthday on 18 June 2010. This was a post-March 2006 IIP and is therefore **NOT a qualifying IIP**. Suzanne's share of the fund is therefore **relevant property** and will be subject to exit and principal charges. Therefore an exit charge will arise when Suzanne becomes 30 in June 2019.

   Suzanne's share of the trust fund became **relevant property with effect from 6 April 2008**. Therefore when counting the number of completed quarters for the purposes of exit or principal charges, we use 6 April 2008 as the date the trust assets became relevant property.

6) The first **principal charge will be in January 2016**. This will be a percentage of the relevant property in the trust at that date. By January 2016, only Suzanne will be under the age of 30. Her share of the fund is relevant property and will be subject to the principal charge. The rate of tax on a principal charge will be calculated using;

   - the **current value of relevant property**; and
   - the **initial value of non-relevant property**.

     It will also take account of chargeable distributions in the previous 10 years.

   The number of quarters will be adjusted to reflect that the trust assets were not relevant property until 6 April 2008.

13.5 IIP trusts and double grossing

Where a death estate contains a qualifying IIP, there could be an interaction between the settled property rules and double grossing.

Illustration 5

Frances died in January 2011. She had made lifetime transfers of £203,000 in the 7 years before her death. She left a free estate valued at £675,000.

She was also the life tenant of an interest in possession trust set up by her uncle on his death in 1997. The capital value of the trust was £360,000 and the trust assets reverted to Frances' niece, Ava, on her death.

In her will Frances left a specific legacy of £200,000 (expressed to be free of tax) to her sister, Lesley, with the residue of her estate split between her husband, Doug and her daughter Roslyn.

We will show the IHT payable and how Frances' estate will be divided.

The trust is a qualifying IIP for Frances as the trust was set up on death. The trust assets will therefore form part of her estate.

Double grossing is required because we have:

- A tax free legacy; and
- A partly exempt / partly taxable residue.

We must then follow the 6-step double grossing procedure as outlined in your IHT manual. However this will be slightly flexed as follows:

1) Gross up the tax free legacy as if it was the only part of the estate chargeable to IHT (a "single grossing" calculation);

2) Calculate the chargeable value of the **FREE ESTATE ONLY** (i.e. ignoring the settled property) and compute notional tax based on this estimated value;

3) Use the notional tax to work out an "estate rate";

4) Using this estate rate, gross up the tax-free legacy as in Step 1 ("double gross");

5) Calculate the chargeable value of the **WHOLE ESTATE** (including the qualifying IIP) and compute IHT based on this value. This gives actual tax payable;

6) Recompute the estate rate and use this to show the burden of tax and how the estate is to be distributed.

Step 1: Gross up the tax-free legacy as if it was the only part of the estate chargeable to IHT (i.e. "single grossing");

	£
Chargeable estate (assumed)	200,000
Less: nil band £(325,000 – 203,000)	(122,000)
Taxable	78,000
IHT @ 40/60	£52,000
Gross legacy £(200,000 + 52,000)	£252,000

Step 2: Calculate the chargeable value of the FREE estate and compute notional tax based on this estimated value;

	£
Total free estate	675,000
Less: gross legacy	(252,000)
Residue	423,000
50% chargeable to tax	£211,500

Taxable free estate:	
£(252,000 + 211,500)	463,500
Less: nil band	(122,000)
Taxable	341,500
IHT @ 40% (notional)	£136,600

Step 3: Use the notional tax to work out an "estate rate";

Estate rate:

$$\frac{136{,}600}{463{,}500} \times 100 \qquad 29.4714\%$$

Step 4: Using this estate rate, gross up the tax-free legacy ("double gross");

$$£200{,}000 \times \frac{100}{100 - 29.4714} \qquad £283{,}573$$

This is now the gross amount (before tax) of the specific legacy to Lesley.

Step 5: Calculate the chargeable value of the gross estate (including the qualifying IIP) and compute IHT based on this value. This gives the actual IHT payable.

	£
Total free estate	675,000
Less: gross legacy	(283,573)
Residue	391,427
50% chargeable to tax	195,713
Add: Gross legacy	283,573
Add: Qualifying IIP	360,000
Chargeable estate	839,286
Less: nil band	(122,000)
Taxable	717,286
IHT @ 40% (actual)	£286,914

Step 6: Recompute the estate rate and use this to show the burden of tax and how the estate is to be distributed.

Estate rate:

$$\frac{286{,}914}{839{,}286} \times 100 \qquad 34.1855\%$$

Tax on tax-free gift to Lesley;	
£283,573 x 34.1855%	96,941

Tax on chargeable residue;	
£195,713 x 34.1855%	66,905
Tax on qualifying IIP;	
£360,000 x 34.1855%	123,068
Total	£286,914

The tax on the tax-free legacy to Lesley (£96,941) will be suffered equally (£48,470 each) by the residuary legatees (Doug and Roslyn).

The tax on the chargeable residue will be suffered by Roslyn.

The tax on the qualifying IIP will be suffered by the remainderman (Ava).

	£
Legacy to Lesley	200,000
½ Residue to Doug £(237,500 – 48,470)	189,030
½ Residue to Roslyn £(237,500 – 48,471 – 66,905)	122,124
Trust assets to Ava £(360,000 - 123,068)	236,932
IHT to HMRC	286,914
Total estate	1,035,000

Example 1

Mr Roscoe died in November 2009. He had made no lifetime transfers and left his estate to his daughter. His only assets of any value were;

- his family home worth £400,000; &
- 40% of the shares in Roscoe Properties Ltd (a property dealing company).

Mr Roscoe also had a life interest in a trust set up by his father in 2002. The trust's only asset was a 40% holding in Roscoe Properties Ltd. Mr Roscoe's son took a successive life interest on his death.

A 40% holding in Roscoe Properties Ltd was worth £200,000. An 80% holding was worth £500,000.

The trustees sold their 40% shareholding in July 2010 for £210,000.

Calculate the IHT payable as a result of Mr Roscoe's death and show who will pay the tax. Assume all appropriate claims are made.

Example 2

The Sinclair Grandchildren's Settlement was created by Mark Sinclair on 1 March 2003 with £600,000 in cash. This was Mark's first transfer. The trust gives the beneficiaries an interest in possession at age 25, and an entitlement to trust capital at age 30.

The beneficiaries are Mark's 2 grandchildren;

Jade	Born 7 December 1981
India	Born 20 May 1985

On 13 August 2010, the trustees made a capital distribution of £100,000 to Jade. Jade will pay any IHT arising.

Calculate the IHT payable on the capital appointment.

Answer 1

	£	£
Free Estate:		
House	400,000	
Roscoe Properties Ltd (40/80 x £500,000)	250,000	
		650,000
Qualifying IIP:		
Roscoe Properties Ltd (40% holding)		200,000
		850,000
Less; nil band		(325,000)
Taxable estate		525,000
IHT @ 40%		£210,000
Payable by Executors:		
£210,000 x 650/850		£160,588
Payable by Trustees:		
£210,000 x 200/850		£49,412

Note: the trust is a pre-2006 IIP and is therefore a qualifying IIP for Mr Roscoe.

The shares in the free estate and the shares in the trust must be valued together for IHT. The IHT value of a 40% holding is therefore 40/80 of an 80% holding.

The trustees sell their shares within 3 years for less than the IHT value (£250,000), so a claim can be made under S.176 IHTA. The effect of the claim is to substitute a "stand alone" value (ie, £200,000) in place of the amount originally charged.

Answer 2

Jade acquired an interest in possession in the trust on her 25th birthday on 7 December 2006. As this is a post-March 2006 IIP, it is NOT a qualifying IIP. Instead the trust assets are relevant property with effect from 7 December 2006.

The exit charge on the capital distribution is therefore;

	£
Initial value of trust	600,000
Less: nil band at exit	(325,000)
	275,000
Notional tax @ 20%	55,000
Effective rate: $\frac{55{,}000}{600{,}000} \times 100 = 9.167\% \times 30\%$	2.75%
Actual rate: $2.75\% \times \frac{29 - 15}{40}$	0.9625%
Exit charge: £100,000 x 0.9625%	£962

Note:

Quarters: 1.3.03 – 13.8.10	29
Quarters: 1.3.03 – 7.12.06	15