

Interest in Possession Trusts – Whys and Wherefores

The interest in possession trust is a common form of trust. It gives the beneficiary an immediate right to the income from the trust. Such trusts are commonly used in will planning whereby a spouse is left property on trust for their lifetime (a 'life interest'). This gives the spouse (described as a 'life tenant' in trust terminology) a right to income for life, but on the spouse's death the underlying assets pass to the children. Interest in possession trusts are usually used in order to protect capital.

With proper drafting, such trusts can be quite flexible. The passing of assets by the settlor into an interest in possession trust is normally a potentially exempt transfer (PET) for Inheritance Tax (IHT) purposes, so if the settlor survives for seven years, no IHT is chargeable on the transfer. However, there can sometimes be problems with Capital Gains Tax (CGT) as the transfer into the trust is a chargeable disposal for CGT and there is no general relief for gifts into such a trust. However, there are certain reliefs ('holdover reliefs') for gifts of business assets, shares in trading companies and agricultural assets, which act to prevent an immediate charge to CGT on the donor. The effect of the operation of holdover reliefs is that the trust takes the asset at the original cost to the donor for CGT purposes. It may in some circumstances be better not to make a holdover relief claim and to pay a small amount of CGT on the gift rather than to have the trust pay a larger amount on the subsequent disposal of the asset.

Trustees of interest in possession trusts pay tax (currently) at 22 per cent on the trust's non-savings income, 10 per cent on dividends and 20 per cent on other savings income, such as interest. The expenses of the trust are set off against dividend income first, then other savings income, then non-savings income. The trustees have an annual exemption for CGT of (currently) £4,250 and gains exceeding this figure are taxed at 40 per cent.

When the trust is wound up (i.e. the assets are distributed) there may be an IHT charge if the winding up is due to the death of the person entitled to the trust income or if the individual's interest in the trust terminates during his lifetime. There is no charge where the trust assets pass back to the settlor, or the settlor's spouse within two years of the death of the settlor. There is no charge to CGT when a life interest terminates unless the assets pass to the life tenant absolutely. Where there are a number of beneficiaries entitled to an interest in land, the transfer of which is contingent on reaching a certain age, the transfer for CGT purposes occurs when the youngest beneficiary reaches the required age. It is therefore usually sensible to transfer the assets showing the lowest gains first, as this delays the CGT liability.

One advantage of such trusts is that when the life tenant dies, the asset values are uplifted to current market values for CGT purposes. One downside, however, is that taxable gains previously not taxed due to holdover relief claims then fall to tax unless further claims for holdover relief are made. This is usually, but not always, possible.

In a later article we will be looking at tax planning possibilities using interest in possession trusts. If you have assets you wish to protect and are considering the use of trusts, contact Liz Stephen or Ailsa Jarvis Tel: 0113 201 4900.