CHAPTER 13

INTEREST IN POSSESSION TRUSTS – FURTHER ASPECTS

In this chapter you will cover further aspects of interest in possession (IIP) trusts including:
- Cessation of an interest in possession;
- Valuing a qualifying IIP;
- Trusts for disabled persons;
- Qualifying IIP in A&M trusts;
- IIP trusts and double grossing.

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 interest in possession depends on:

a. Whether the interest in possession was a “qualifying IIP” or “relevant property”; and
b. Whether capital assets leave the trust or another beneficiary takes a successive interest in possession.

13.2 Lifetime cessation of a “Qualifying IIP”

i. Assets leaving the trust:

If a qualifying IIP ends during the lifetime of the life tenant and the underlying capital assets pass to another beneficiary, this is usually a PET by the life tenant. This is because assets will leave his estate and move to someone else’s. IHTA 1984, s.52

The exceptions to this general rule 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).
ii. Beneficiary taking a successive life interest:

The position is different if a qualifying IIP ends during the lifetime of the life tenant and another beneficiary takes a successive interest without assets leaving the trust.

In this case there is a transfer of value because assets will be leaving the estate of the life tenant with the qualifying IIP.

However, where a beneficiary receives an interest in possession on or after 22 March 2006, this will not be a qualifying IIP. Instead the new IIP will be treated as relevant property.

Therefore, as assets will move from the estate of the life tenant and into the relevant property regime, the transfer will be immediately chargeable to inheritance tax.

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

➢ Illustration 1

Andrew created an interest in possession trust for his nephew, Bradley, in June 2003. 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 is 30 on 4 April 2016.

Discuss the IHT implications.

• 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 2016, his 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 2016 (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 2023).
Illustration 2

David died in August 2012 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 2016; or

2. Eunice re-maries in 2017.

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 2016 – 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-maries in 2017 – 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 2024). There is no exit charge as the assets are not “relevant property”.

13.3 Lifetime cessation of a “non-qualifying IIP”

If the life tenant does not have a qualifying IIP, the underlying trust assets are not in his estate. Therefore a cessation of the interest in possession will not be a transfer of value by the life tenant for IHT purposes.

Instead, the trust assets will be relevant property. Therefore:

a. If the cessation of the IIP causes assets to leave the trust, an exit charge will arise; but

b. If the cessation of the IIP does not result in assets leaving the trust (for example, if another beneficiary takes a successive IIP), there are no IHT implications

13.4 Valuing a Qualifying IIP

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 (i.e., 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

13.5 Trusts for Disabled Persons

There is special IHT treatment for trusts set up for disabled persons. IHTA 1984, s.89

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; and
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, if the trust property is applied during the lifetime of the disabled person, it must, subject to limited exceptions, be applied for the benefit of the disabled person.

13.6 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;
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 and maintenance (A&M) trusts created before 22 March 2006 were protected from IHT until 6 April 2008. Thereafter such “old” A&M trusts usually came **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 1997 for his 4 grandchildren:

<table>
<thead>
<tr>
<th>Name</th>
<th>Date of Birth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alexandra</td>
<td>Born 27 March 1982</td>
</tr>
<tr>
<td>Simon</td>
<td>Born 26 June 1984</td>
</tr>
<tr>
<td>Victoria</td>
<td>Born 5 November 1986</td>
</tr>
<tr>
<td>Suzanne</td>
<td>Born 18 June 1991</td>
</tr>
</tbody>
</table>

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. 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 2007.

2. Alexandra acquired an IIP in one-quarter of the fund from her 21st birthday in March 2003. 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 2012. 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 became 30 in June 2014, the assets moved into his free estate. There was **no IHT charge at this point**. This part of the fund is not relevant property and not subject to exit charges.

4. Victoria acquired an IIP in one-quarter of the fund from her 21st birthday in November 2007. 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 2016.

Victoria's share of the trust fund became relevant property with effect from 5 November 2007 (not from 6 April 2008). Therefore when counting the number of completed quarters for the purposes of the exit charge, we use 5 November 2007 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 2012. 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 2021.

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 2017. This will be a percentage of the relevant property in the trust at that date. By January 2017, 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.
13.7 IIP Trusts and Double Grossing

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

Illustration 5

Frances died in January 2016. 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 on Frances's death 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.

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 assets in the trust) 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”):

<table>
<thead>
<tr>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chargeable estate (assumed)</td>
</tr>
<tr>
<td>Less: Nil band (325,000 – 203,000)</td>
</tr>
<tr>
<td>Taxable</td>
</tr>
<tr>
<td>IHT @ 40/60</td>
</tr>
<tr>
<td>Gross legacy (200,000 + 52,000)</td>
</tr>
</tbody>
</table>
Step 2

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total free estate</td>
<td>£675,000</td>
</tr>
<tr>
<td>Less: Gross legacy</td>
<td>(£252,000)</td>
</tr>
<tr>
<td>Residue</td>
<td>£423,000</td>
</tr>
<tr>
<td>50% chargeable to tax</td>
<td>£211,500</td>
</tr>
<tr>
<td>Taxable free estate</td>
<td>£463,500</td>
</tr>
<tr>
<td>Less: Nil band</td>
<td>(£122,000)</td>
</tr>
<tr>
<td>Taxable</td>
<td>£341,500</td>
</tr>
<tr>
<td>IHT @ 40% (notional)</td>
<td>£136,600</td>
</tr>
</tbody>
</table>

Step 3

Use the notional tax to work out an “estate rate”:

Estate rate:

\[
\frac{136,600}{463,500} \times 100 = 29.4714\%
\]

Step 4

Using this estate rate, gross up the tax-free legacy (“double gross”):

\[
200,000 \times 100/(100 - 29.4714) = £283,573
\]

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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total free estate</td>
<td>£675,000</td>
</tr>
<tr>
<td>Less: Gross legacy</td>
<td>(£283,573)</td>
</tr>
<tr>
<td>Residue</td>
<td>£391,427</td>
</tr>
<tr>
<td>50% chargeable to tax</td>
<td>£195,713</td>
</tr>
<tr>
<td>Add: Gross legacy</td>
<td>£283,573</td>
</tr>
<tr>
<td>Add: Qualifying IIP</td>
<td>£360,000</td>
</tr>
<tr>
<td>Chargeable estate</td>
<td>£839,286</td>
</tr>
<tr>
<td>Less: Nil band</td>
<td>(£122,000)</td>
</tr>
<tr>
<td>Taxable</td>
<td>£717,286</td>
</tr>
<tr>
<td>IHT @ 40% (actual)</td>
<td>£286,914</td>
</tr>
</tbody>
</table>
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:
\[
\frac{286,914}{839,286} \times 100 = 34.1855\%
\]

Tax on tax-free gift to Lesley:
\[
283,573 \times 34.1855\% = 96,941
\]

Tax on chargeable residue:
\[
195,713 \times 34.1855\% = 66,905
\]

Tax on qualifying IIP:
\[
360,000 \times 34.1855\% = 123,068
\]

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).

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legacy to Lesley</td>
<td>£200,000</td>
</tr>
<tr>
<td>½ Residue to Doug (237,500 − 48,470)</td>
<td>£189,030</td>
</tr>
<tr>
<td>½ Residue to Roslyn (237,500 − 48,471 − 66,905)</td>
<td>£122,124</td>
</tr>
<tr>
<td>Trust assets to Ava (360,000 − 123,068)</td>
<td>£236,932</td>
</tr>
<tr>
<td>IHT to HMRC</td>
<td>£286,914</td>
</tr>
<tr>
<td>Total estate</td>
<td>£1,035,000</td>
</tr>
</tbody>
</table>
EXAMPLES

Example 1

Mr Roscoe died in November 2015. 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 2016 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 21 February 2006 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 35.

The beneficiaries are Mark's 2 grandchildren:

- Jade Born 7 December 1982
- India Born 20 May 1987

On 13 August 2015, 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.
ANSWERS

Answer 1

<table>
<thead>
<tr>
<th>Description</th>
<th>£</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free Estate:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>House</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Roscoe Properties Ltd (40/80 × 500,000)</td>
<td>250,000</td>
<td>650,000</td>
</tr>
<tr>
<td>Qualifying IIP:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Roscoe Properties Ltd (40% holding)</td>
<td>200,000</td>
<td>850,000</td>
</tr>
<tr>
<td>Less: Nil band</td>
<td></td>
<td>(325,000)</td>
</tr>
<tr>
<td>Taxable estate</td>
<td></td>
<td>525,000</td>
</tr>
<tr>
<td>IHT @ 40%</td>
<td></td>
<td>210,000</td>
</tr>
<tr>
<td>Payable by Executors: 210,000 × 650/850</td>
<td></td>
<td>160,588</td>
</tr>
<tr>
<td>Payable by Trustees: 210,000 × 200/850</td>
<td></td>
<td>49,412</td>
</tr>
</tbody>
</table>

Tutorial 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 (i.e. £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 2007. 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 2007.

The exit charge on the capital distribution is therefore:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial value of trust</td>
<td>£600,000</td>
</tr>
<tr>
<td>Less: Nil band at exit</td>
<td>(£325,000)</td>
</tr>
<tr>
<td><strong>Notional tax @ 20%</strong></td>
<td>£55,000</td>
</tr>
<tr>
<td>Effective rate:</td>
<td>2.75%</td>
</tr>
<tr>
<td>(\frac{55,000}{600,000} \times 100 = 9.167% \times 30%)</td>
<td></td>
</tr>
<tr>
<td>Actual rate:</td>
<td>2.062%</td>
</tr>
<tr>
<td>(2.75% \times \frac{(37-7)}{40} (W))</td>
<td></td>
</tr>
<tr>
<td>Exit charge:</td>
<td>£2,062</td>
</tr>
<tr>
<td>(100,000 \times 2.062%)</td>
<td></td>
</tr>
<tr>
<td><strong>Working</strong></td>
<td></td>
</tr>
<tr>
<td>Quarters: 21.2.06 – 13.8.15</td>
<td>37</td>
</tr>
<tr>
<td>Quarters: 21.2.06 – 7.12.07</td>
<td>7</td>
</tr>
</tbody>
</table>