
The Personal Tax Planning Review

IN PRAISE OF THE FLEXIBLE LIFE INTEREST TRUST: LIFETIME ARRANGEMENTS

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The House of Lords decision in *Pearson v IRC* [1980] STC 318 defines such an interest in possession as a present right of present enjoyment. An interest in possession includes enjoyment of the assets. A mere power to accumulate prevents the existence of an interest in possession; by contrast, a power of revocation and appointment away from the life tenant does not prevent such existence and this gives rise to the advantageous flexible use of this trust.

For inheritance tax (IHT) purposes such a trust can be harmless, for example insofar as the transfer into and out of such a trust is, since 17th March 1987, normally subject to the potentially exempt transfer (PET) regime; moreover, when a beneficiary becomes absolutely entitled to trust assets, there is no IHT charge at that stage.

Under a typical flexible life interest trust one or more life interest beneficiaries are given an interest in possession, in particular the right to the income and use of the trust assets, under the main clause in the trust deed; but subject to a prior clause which contains very wide overriding powers of appointment and revocation. Therefore at any time the interest of the life tenant in whole or part can be revoked and the capital so released appointed absolutely or on other trusts to other named or designated beneficiaries. Moreover, such other beneficiaries can be extremely widely defined, including a power to **add** beneficiaries, although it is clearly of vital importance that, in such power to add, the settlor and spouse excluded. It is of fundamental importance that the inclusion as a beneficiary of a widow(er) has no tax disadvantages whatsoever because a widow(er) is not a "spouse" (there is now statutory authority for this in ICTA 1988 s.660A as introduced by FA 1995 Sch 17).

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Some of the most important taxation mitigation uses of such trusts are summarised below:

- IHT: 100% business/agricultural property relief plus CGT exemption and market value uplift on death of life tenant. Given that an estate owner has business or agricultural assets eligible for the 100% (50%) relief and such assets are retained in the trust, the position is extremely beneficial from a tax viewpoint; the transfer into the trust is exempt, subject to careful awareness of the claw-back provisions in IHTA 1984 ss.113A and 124A. Moreover, the termination of the life interest during lifetime or on death will be in effect exempt from IHT providing the assets remain eligible for business or agricultural property relief and the law has not changed. This type of arrangement has a dual importance in that on the death of the life tenant there is also the capital gains tax (CGT) death exemption and market value uplift under TCGA 1992 s.73 subject to the exceptional circumstances in s.74 where there has been a hold-over election.
- Purchase of own shares using interest in possession trusts. Such an arrangement can have remarkable results where a negative clearance is obtained for the purchase to be treated as a Schedule F distribution with the likely result that there will be no IHT, CGT, corporation tax (the advance corporation tax being set against the mainstream liability) and no income tax because from a trust law point of view the purchase is treated as part of the capital of the trust fund and therefore not income in the hands of the life tenant. It is usually advisable to obtain a further clearance under ICTA 1988 s.703 (transactions in securities anti-avoidance provisions) and the Revenue will attack the arrangements if the settlor or spouse are beneficiaries of the life interest trust.
- IHT: segregating value. A Revenue change in practice on valuation was announced in May 1990 (see *Law Society's Gazette* no. 17, 9th May 1990 page 4). Accordingly, where a life interest is terminated during lifetime (although not on death) and the life tenant has in addition to his life interest in respect of a particular asset, e.g., shares in a company, a beneficial ownership of other such shares, the two holdings are valued separately and not in aggregation. This can of course give rise to very useful share valuation advantages.
- For CGT, as settlor and trustees are "connected" (TCGA 1992 s.286), one should consider the possibility of the settlor setting losses against gains on creating such an interest in possession for himself.
- CGT rates. Interest in possession trusts are subject to the lowest rate of CGT, namely only 24% basic rate, where trustees make a disposal, provided the settlor and spouse (but not necessarily widow(er)) are fully excluded: TCGA 1992 ss.77 to 79.

- Reversionary interests: CGT, IHT and stamp duty. The owner of a reversionary interest is able to assign this by way of gift without incurring
- CGT (TCGA 1992 s.76) or IHT (as excluded property: IHTA 1984 s.48); and free of stamp duty as being a gift.

The use of interest in possession trusts in Wills can also have very significant advantages and this is planned for a subsequent article.

It is of course a truism that, with the General Election just around the corner, the present bonanza for these and other types of trust and estate planning generally is likely to be severely curtailed. Estate owners need to grasp the nettle now.