REVOCABLE INTERESTS IN POSSESSION: SOME FURTHER THOUGHTS

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Alan Pink's thought-provoking article in Volume 3 Issue 3 of this *Review* has prompted this brief contribution.

That article was recommending the use of a structure first (to my knowledge) propounded by James Kessler some five years ago. The essence of the idea is, on the death of the first of a married couple to die, the combination of inheritance tax efficiency (by making full use of the nil-rate band through a share in the matrimonial home) with capital gains tax mitigation (in using the special regime for trustees owning a private residence, under section 225 of the Taxation of Chargeable Gains Act 1992). The idea is that the testator's share in the home (whether or not owned with the surviving spouse as tenant in common) is left to trustees of a life interest trust in which, assuming the value of the share exceeds £154,000, a proportionate part equal to £154,000 (or whatever was the unused portion of the nil-rate band at death) is left on life interest trusts for the children, typically in equal shares, with a life interest in the balance for the surviving spouse.

The essence of the capital gains tax aspects of the scheme is that the main residence exemption given to trustees by section 225 requires only one of a number of the beneficiaries (if more than one there be) to reside in the house with the consent of the trustees. The fact that the children have no absolute rights to ownership means that the surviving spouse's security of tenure is preserved, especially (and I return to this below) in that if necessary the interest of any one or more of the children can be taken away from them.

The scheme expressly avoids a discretionary trust since there will often be the fear, whether or not borne out in practice, that the Capital Taxes Office will apply the principles enunciated in Statement of Practice 10/79 to argue that on the second

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death the surviving spouse had in reality an interest in possession in the late spouse's share settled on trust, thereby aggregating the value of the trustees' share with the free estate and obviating the hoped-for inheritance tax efficiency of the scheme. A number of arguments have been propounded to support the contention that a discretionary trust can be used while avoiding the ambit of SP 10/79 (e.g., relying on the surviving tenant in common's half share to entitle occupation, having no power in the trust to allow a beneficiary to occupy a dwelling-house or share therein comprised in the trust, expressly excluding the surviving spouse from benefit, etc.), with which I do not propose to deal here. Suffice it to say, however, that I for one would much rather avoid relying on a technicality to escape the letter as opposed to the spirit of SP 10/79 and, in my view, it is better to steer clear of discretionary trusts altogether.

Most of the above is by way of background. I was prompted to write these further thoughts by Alan Pink's final paragraph "Only if it is necessary to revoke the interest in possession for the children in favour of the surviving spouse will the inheritance tax planning be ineffective, the property becoming thereby part of the surviving spouse's estate for IHT purposes in its entirety".

Why might one wish to revoke the children's interest in possession? Clearly, they must not be excluded from occupation, since as beneficiaries with an interest in possession they will have a right to occupy the former matrimonial home with their surviving parent. Indeed, if they are so excluded, it is clear from correspondence I have had with the Capital Taxes Office that they will claim (with justification) that the surviving spouse had an interest in possession in the whole property. As Alan Pink observes, in 99 cases out of 100 the children will not want to occupy the house. Further, interestingly, there is decided case authority in *Dennis v MacDonald* [1982] 1 All ER 590 that the trustees are not obliged (e.g.,for their professional protection) to charge the mother an occupation rent in respect of the trustees' share, which is useful. Nonetheless, some professional trustees may feel safer if they get the written consent of the children to their not charging the occupying beneficiary a rent (for example, in the light of their duty to balance the respective interests of the income and the capital beneficiaries).

It is likely, therefore, that the trustees would want to revoke that interest only if one of the children, e.g., prompted by an 'undesirable' son/daughter-in-law, tried to challenge the trustees in some way or perhaps even faced the threat of insolvency or matrimonial proceedings. However, in my view, there is no reason why the interest of, say, one of three siblings should not, through exercise of an overriding power of appointment, be given to the other or others of them; this therefore would retain the inheritance tax efficiency of the scheme so far as the surviving spouse is concerned. There is no reason indeed why the trusts outside the surviving spouse's estate should not grant interests in possession for grandchildren (rather perhaps than accumulation and maintenance trusts), again all subject to the same overriding powers of appointment.

Of course, the termination of an interest in possession will typically constitute a potentially exempt transfer, subject to any available annual exemptions, likely to become completely exempt on survival of the beneficiary for seven years. Such 'chopping and changing' of interests within a trust can be done without any capital gains tax and (assuming such survival or at least not substantial values) in a relatively inheritance tax free way under the present regime. Do bear in mind that if within the next couple of years we have a Labour rather than a Conservative administration, then the shape of gifts taxation may change dramatically, perhaps (in particular) with a return to lifetime cumulation, and therefore the ability to do this may be diminished. Even so, so long as any trust has in-built maximum flexibility in terms of exercise of powers, reaction can be made as may be most appropriate to any new legislation.

As well as keeping the trust interest outside the estate of the surviving spouse, there is also a valuation point: in valuing the combined interest of the spouse, resulting from aggregating her free estate with the value of her small interest in possession, typically a discount of 10-15% from a pro rata share in the whole property will be available (which would not be the case if he/she had a beneficial interest in the whole property through a combination of free estate and trust interest).

Consider also the following reservation of benefit point, likely to apply in a case where the value of the interest owned by the first spouse to die exceeds the nil-rate band. Suppose the husband owned the whole house worth £300,000. Under his Will or by Deed of Variation the whole interest could be put into a life interest trust under which the surviving wife had, say, 50% and the children 50%. However, the trustees could then exercise their powers to diminish the wife's interest and increase the children's interest to, say, 10%/90%, leaving the spouse with just £30,000 (subject to discount) in her estate. This would take effect as a potentially exempt transfer by her, but significantly would not trigger the reservation of benefit provisions under section 102 of and Schedule 20 to the Finance Act 1986, since that termination would be occasioned by an act of the trustees and would not be a disposition by way of gift by the wife. This could be a useful facility.

The capital gains tax efficiency of the scheme of course depends upon the spouse being a beneficiary under the settlement. It is suggested that something of reasonable substance, e.g., 10%, is sensible.

A final thought on capital gains tax. Though I share Alan Pink's desire to find a solution that combines capital gains tax with inheritance tax efficiency, I suspect that at present at least it is a point of more significance in theory than in practice, (assuming that we are unlikely to see the significant gains we had in the late 1980s). However, there is no reason why one should not in principle aim for capital gains tax efficiency, given that only one occupying beneficiary is needed since, perhaps somewhat surprisingly, section 225 contains no pro rata test. If the surviving spouse does have another residence, remember that any election has to be made within two years after the acquisition of the second residence (following *Griffin v Craig-Harvey* [1994] STC 54) and that the trustees must join in. In practice an election would be made in favour of the residence which was going to be sold first (if at a gain), in the hope perhaps that the other might be retained until death with the benefit of the tax-free uplift to market value. Alternatively, if both properties were to be sold inter vivos, then it might be possible, if (say) mother had living with her an unmarried daughter, to rely on the unmarried daughter's occupation of the trust property to attract the section 225 exemption.

No doubt this particular debate can run and run (and of course there are other possible structures for making efficient use of the nil-rate band on the first death with a share in the family home, e.g., through the debt or charge route), but it is hoped that these words will have given readers some further ideas.