

VESTED OR CONTINGENT INTEREST? SOME PRACTICAL CONSEQUENCES

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Problem

Imagine these not unusual circumstances: T dies predeceased by his spouse but survived by his children who are all under the age of 18. His sister and brother (A and B) aged respectively 28 and 30 and each of whom has children under the age of 18, also survive him. Aside from containing specific provision for his children, T's will directs the residue to be held on the following terms:

"upon trust for my sister A and my brother B in equal shares upon their respectively attaining the age of 40 years and if only one of them shall attain the age of 40 years then for that one absolutely PROVIDED NEVERTHELESS that if A and B or either of them shall have died in my lifetime or after my death but before attaining the age of 40 years leaving a child or children living who attain the age of 18 years then such child or children shall take and if more than one equally between them the share or shares which his her or their parent would have taken in my Residuary Estate had such parent survived me and attained a vested interest".

The experienced draftsman instinctively winces at the first line: ("I always say "to *such of* A and B as survive me ...") but may find it difficult to explain exactly why. Choice of wording depends, as always, on the desired result: given that the world of the draftsman is infinite in its variety, what is the consequence of the wording which the author of my example has chosen? The question is simply whether A and B (before attaining the specified age) have interests which are vested or contingent. The unsimple answer may have some unexpected (as well as familiar) consequences for will administration and tax purposes.

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Vested or Contingent?

In broad terms, the residuary gift envisages three possible sets of events:

A and B both reach the age of 40 and become indefeasibly entitled;

One or both of them dies or die before the age of 40 leaving children who reach the age of 18 taking their own parent's share;

A or B dies before reaching the age of 40 without leaving children. The survivor takes the whole.

No express provision is made for the childless death before the age of 40 of both A and B.

The general rule of construction known as the rule in *Phipps v Ackers*² is as formulated in *Williams on Wills* 6th ed. Vol. 1 at p.681:

"Where property is devised to a devisee "if" or "when" he attains a certain age, and there is a gift over in the event of his failing to attain that age, with or without other contingencies, the attainment of that age is held to be a condition subsequent, and not precedent, and the gift is vested immediately subject to be divested if the devisee dies under the specified age".

The rule does not apply where the contingency is part of the description of the donee, for example where the gift is to such of a class as attain the specified age³ hence the more usual drafting as a class gift. Nor does it apply where there is an express direction as to vesting: *Russel v Buchanan*⁴.

On the postulated facts, there would be little doubt that the gifts to A and B fell within the rule in *Phipps v Ackers* (because the gift is not a class gift but to each of them individually with gifts over) were it not for the final reference to their children taking by substitution the parent's interest "had such parent survived me and attained a vested interest". The possible inference here is that neither A nor B is to take a vested interest until he or she reaches the specified age. The question is, accordingly, whether that reference constitutes an express direction as to vesting within *Russel v Buchanan* (supra) or otherwise excludes the rule in

² (1842) 9 Cl & Fin 583

³ *Duffield v Duffield* (1829) 3 Bli NS 260 *Festing v Allen* (1843) 12 M & W 279.

⁴ (1836) 7 Sim 628.

Phipps v Ackers. Although the reference in my example contrasts with the very express direction in *Russel v Buchanan* there is clearly a respectable argument that as a matter of construction the will in my example displaces the rule in *Phipps v Ackers*. But there is such uncertainty about that as to highlight the advantages of certainty to be gained by the inclusion of a class gift.

What are the Consequences?

Assuming (as is not always easy) that it is possible to identify which is which in an individual case, a number of important consequences flow from distinguishing between an interest which is vested subject to being divested and one which is contingent. The distinction is immaterial for the purposes of distribution of capital until the happening of some relevant future event. If their interests are vested they are only vested *in interest* and not *in possession*. Only when they attain the specified age (or, perhaps, both die before such age leaving no children: see below) will they be entitled to call for the trust property to be vested in them. For the present the trustees will be obliged to retain the trust property on the trusts of the will and could not vest it in the beneficiaries. Their duty to those who may take under the gifts over to preserve the trust capital in case of the possibility of defeasance (subject, of course, to any proper exercise of the power of advancement under s.32 Trustee Act 1925 or other express power of application) dictates that they could not safely part with the capital until the beneficiaries' interests become indefeasible.

But the following are the major differences:

1. A and B's entitlement to *income* before attaining the specified age may differ in a rather surprising way according to the true analysis of their interests in capital. If their interests are contingent the provisions of s.31(1)(ii) of the Trustee Act 1925 and s.175 Law of Property Act 1925 will operate to entitle them to income until they attain vested interests at 40. If they are vested, on the other hand, the perhaps unexpected difficulty is that a future defeasible gift of residue does not (apart from express provision in the will or by necessary implication) carry the intermediate income⁵. Such a gift is not assisted by the provisions of s.175. If there is no express provision in the will, and in the absence of necessary implication, the income will be undisposed of and go as on intestacy⁶. Should the serendipitous circumstances be that A and B are the persons entitled on T's

⁵ *Bective v Hodgson* (1864) 10 HL Cas 656 and *Re Gillett's Will Trusts* [1950] Ch 102.

⁶ *Re Geering* [1964] Ch 136.

intestacy no problem arises but in my example those persons are different: in fact they are a class of minor children whose "entitlement" to income may give rise to unexpected results;

2. Different income tax consequences flow depending on the nature of the income interest. In my example the income trust in favour of the minor beneficiaries entitled on intestacy will, given the provisions of s.31 Trustee Act 1925, be an accumulation and maintenance trust for income tax purposes under which additional rate income tax will be payable⁷. It will be otherwise if the persons entitled have a vested and indefeasible right to the income. The consequences of the distinction are much the same for capital gains tax purposes: if the income interests amount to an accumulation or discretionary trust under s.5 Taxation of Chargeable Gains Act 1992 the rate of CGT will be a rate equal to the sum of the basic and additional rates for income tax;

3. The effect of the childless death of both A and B before the age of 40 will differ according to the nature of the interests. If their interests are contingent, then that set of circumstances (not dealt with expressly by the trusts of the will) gives rise to an intestacy. Again, distribution will depend upon entitlement to T's estate on intestacy. If vested, however, the estates of both would probably take under the will (subject to a possible argument in favour of the estate of the survivor only);

4. For inheritance tax purposes, too, the distinction is obviously important: the settled property may or may not constitute relevant property for the purposes of Part III Chapter III of the Inheritance Tax Act 1984 (and be taxed accordingly) depending upon the presence or absence of an interest in possession. The termination of such an interest in possession if the holder is different from A and B may cause an unexpected charge to IHT. The distinction is also important in the context of post-death variations. In circumstances in which no interest in possession subsists in the settled property the provisions of s.144 Inheritance Tax Act 1984 may permit a re-settlement within two years of the death of T in circumstances in which it would be impossible to effect a variation within s.142 IHTA. If, in my example, the executors had, and exercised, powers of application of capital under the will so as to accelerate the interests of A and B, the provisions of the will could be varied in a way that would be impossible under s.142 since the consent of the minor beneficiaries to such a re-arrangement could not be obtained.

⁷ S.686 Taxes Act 1988.

Moral

Unless you consciously wish to achieve a different result, make your gift to A and B a class gift contingent upon attaining the specified age. Result: the gift carries the intermediate income and produces interests in possession in that income.