

Life Interest Trusts

Introduction

This information sheet sets out briefly for general guidance the main features of Life Interest Trusts and their tax implications. A number of important and technical points arise. Specific advice should be obtained before such a trust is used in any particular case.

What is a Life Interest Trust?

Life Interest Trusts are so called because they give a particular beneficiary the legal right to receive the income from, or to use property comprised in, the trust. This right normally lasts throughout the beneficiary's lifetime. Sometimes the right terminates on, for example, the beneficiary's remarriage or on the death of some other person, but this information sheet deals only with life interests which continue until the beneficiary's death.

The beneficiary is often referred to as the life tenant. This is not to be confused with the tenant under a lease.

The trustees may collect the trust income and account for any tax due. If they do, the amount of the trust income which the life tenant is entitled to receive is net of any trust administration expenses which are properly chargeable to the income. Alternatively, the trustees may make arrangements for the trust income (for example, dividends and deposit interest) to be paid directly into the life tenant's bank account. In such circumstances, the trustees will not be separately assessed to Income Tax.

In addition to the life tenant's right to receive the income from, or to use any property comprised in, the trust, the trustees will

usually be given a power to advance some or all of the capital in the trust to the beneficiary. If such a power is included, the trustees will not be required to exercise it, but will be able to exercise it if they consider it appropriate.

The trust will specify what will happen to the capital in the trust, to the extent that any power of advancement has not previously been exercised, on the life tenant's death. At that time, there may be a successive life interest in favour of another beneficiary or trusts in favour of, for example, the life tenant's children. If required, either the trustees or the life tenant can be given either limited or very wide powers to determine who should benefit after the life tenant's death, or such matters may be determined in advance by the person making the trust, known as the settlor.

A Life Interest Trust may continue for up to 125 years from its creation. This was limited to 80 years for trusts created before 5 April 2010. The settlor will provide how any assets which may be left at the end of the trust period must devolve.

Use of Life Interest Trusts

The main use of Life Interest Trusts is where the settlor knows in advance who should benefit under the trust, but where the settlor does not want to confer outright ownership. The trustees will retain control of the trust assets, albeit control which they must exercise in the combined interests of the life tenant and the beneficiaries entitled after the life tenant's death.

The Trustees

The trustees have the job of safeguarding the trust assets and must always act in the

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best interests of the beneficiaries. Particularly if the trustees are given powers to advance capital to the life tenant or to dictate what will happen after the life tenant's death, care must be taken in choosing the trustees. The life tenant can be a trustee, but should not be given power to act as a sole trustee. If required, the settlor can act as a trustee.

Tax Implications

The Inheritance Tax (IHT) and Capital Gains Tax (CGT) rules affecting Life Interest Trusts were radically changed by the 2006 Finance Act, taking effect from Budget day on 22 March 2006.

1 IHT

With the exception of new trusts for some disabled persons, the creation during lifetime of a Life Interest Trust on or after 22 March 2006 is treated as a chargeable transfer by the settlor and the Discretionary Trust charging regime will apply to the trust. These aspects are dealt with in the information sheet Discretionary Trusts.

For trusts made before 22 March 2006, while the existing life interest continues the trust assets are still treated for IHT purposes as being comprised in the life tenant's estate. On the life tenant's death, subject to any exemptions or reliefs which then apply, IHT will be payable on the combined value of the trust assets and the life tenant's own estate. The trustees will be responsible for paying the proportion of the IHT payable in relation to the trust assets. These rules also apply where a life interest in existence at 22 March 2006 was replaced before 6 October 2008 by a successive life interest or, from that date onwards, if the successive life interest

arises on death and is in favour of the surviving spouse*.

A life interest arising on death in a Will or under the intestacy rules will also largely be governed by the pre-2006 Budget IHT rules, with the life tenant being treated as owning the trust assets.

If the life tenant uses the trust assets in connection with the life tenant's business or farming, Business or Agricultural Property Relief may be available to the trustees.

2 CGT

The trustees will be liable to CGT currently at 28% (subject to any entrepreneurs relief) in respect of any gains exceeding the trustees' available annual exemption, presently a maximum of one half of the individual's annual exemption.

Under a trust created before 22 March 2006, on the original life tenant's death the base value of the trust assets will usually be uplifted to their then value without any CGT charge. This uplift wipes out any unrealised gains (except any which have been held over by the settlor to the trustees). The same treatment will apply to a successive life interest which arose before 6 October 2008, and to life interests arising subsequently on the death of a spouse. In almost all other cases there will now be no CGT rebasing on the life tenant's death.

The transfer of chargeable assets into a Life Interest Trust will be a disposal for CGT by the settlor. Any liability to CGT will depend on the settlor's own circumstances. For gifts on or after 22 March 2006 any gains accruing to the settlor may be held over and, in effect, transferred to the trustees (except as mentioned below). This is more

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favourable than for gifts before that date, in respect of which hold-over relief was only available for business assets.

Where the settlor has retained an interest in the trust as a possible beneficiary, it is not possible to hold over gains, even in business assets, to the trust. A settlor is regarded as having an interest if there are any circumstances in which the assets within the trust or the income arising to the trustees may become payable to the settlor or to his/her spouse. The settlor will also be regarded as having an interest if his/her minor and unmarried children or stepchildren can benefit.

Should any beneficiary become entitled outright to the trust assets, the trustees will be treated as if they had disposed of them. Whether or not hold-over relief will be available will depend (except in the case of business assets) on how and when the trust was made.

3 Income Tax

The trustees are generally subject to Income Tax at the basic rate, presently 20%, but pay at 10% in relation to dividends (satisfied by a tax credit). The trustees are not eligible for any personal allowances, nor can they deduct any trust administration expenses when calculating their tax liability. If the life tenant who is entitled to receive the income is taxable at the higher or top rates, the life tenant will have to account to HMRC for a further tax. A life tenant who is a non-taxpayer may reclaim any tax previously paid by the trustees (except the 10% dividend tax credit).

If the settlor or his/her spouse is a possible beneficiary, all the trust income will normally

be taxed in the settlor's hands during the settlor's lifetime.

If income is payable from the trust to a minor, unmarried child or stepchild of the settlor, it will also be taxed in the settlor's hands.

Administration

A Life Interest Trust needs to be properly administered. This usually involves the trustees filing annual Tax Returns and issuing tax deduction certificates to the life tenant, unless all the trust income is paid directly to the life tenant and assessed on the life tenant. The trustees should also maintain trust accounts and properly manage the trust's property or investments. The amount of administrative work will depend on the nature of the trust assets.

Conclusion

A Life Interest Trust may be suitable for an individual who wishes to transfer assets for the benefit of one or more particular beneficiaries without giving them outright control of the assets. Although there will be no discretion about the payment of the income, at least during the life tenant's lifetime, such trusts can otherwise be drawn rigidly or flexibly. The trustees can be given powers partially or completely to terminate the life tenant's income entitlement and to reallocate it, or even to create new trusts.

Disclaimer

This information sheet is written as a general guide. As any course of action must depend on your individual circumstances, you are strongly

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recommended to obtain specific professional advice before you proceed.

We do not accept any responsibility for action which may be taken as a result of having read this information sheet.

NOTE: The law is stated as at 6 April 2011.

If you require further information, please contact Mark Politz, Stuart Goodbody or Simon Brown on 01892 510000 or by email at:

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* All references to the term "spouse" include a civil partner as defined by Section 1 of the Civil Partnership Act 2004

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