

Information

Life Interest Trusts in wills for spouses or civil partners

Introduction

This information sheet sets out briefly the main features of Life Interest Trusts in wills for spouses or civil partners. The technical term for a life interest arising under a will is an “immediate post-death interest”.

On death, a person’s estate is liable to inheritance tax (IHT) at 40% to the extent, if any, that its value exceeds the current threshold of £325,000. The amount below that threshold is called the nil rate band because it is charged to IHT at nil%. It is reduced by gifts made in the 7 years before death and legacies in the will which are not exempt. The unused balance is referred to below as the IHT-free amount.

Assets passing either outright or in trust between spouses or civil partners are exempt from IHT (referred to below as the spouse exemption).

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 earlier, for example on the beneficiary’s remarriage, or if the trustees exercise any overriding powers under the will.

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

In addition to the Life Tenant’s right to receive the income from, or to use any property (including the home) comprised in the trust, the trustees will usually be given a power to distribute some or all of the capital in the trust to the Life Tenant and the beneficiaries entitled after the Life Tenant’s

death (referred to below as the ultimate beneficiaries). The trustees will not be required to exercise such a power, but will be able to do so if they consider it appropriate.

The will specifies what will happen to the remaining assets held in the trust on the Life Tenant’s subsequent death (to the extent that distributions have not been made).

Use of Life Interest Trusts in wills for spouses or civil partners

The Life Tenant does not own the trust assets outright, and the trustees will retain control.

The Life Tenant can benefit from the trust assets, while the capital is preserved for the ultimate beneficiaries. The trust assets will not pass under the Life Tenant’s own will.

One example of when a couple may wish to include such a trust in their wills is where the marriage or civil partnership is a second or subsequent one. While income can be paid to the surviving spouse (the Life Tenant) throughout their lifetime, capital can be preserved for the children of the former marriage or civil partnership.

A further use of a Life Interest Trust is to control the level of income for the purposes of means-tested benefits, with protection in the context of care home fees.

The Trustees

The trustees have the job of safeguarding the trust assets and must always act in the best interests of the beneficiaries. Care must be taken when choosing who should act in this role. The Life Tenant can be a trustee, but should not be the only one. Adult children or other family members can be appointed although, if they also have a

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personal interest in the trust, it may be preferable to appoint one or more professional, or other independent trustees, to reduce potential conflicts of interest. Unless the will provides otherwise, the trustees must act unanimously, so any one of them effectively has a power of veto.

As the trustees are often given wide powers to distribute trust capital, or even to declare that they hold some or all of the trust fund on new trusts (benefiting named beneficiaries), it will be helpful for them to have an indication of the circumstances in which this power might be exercised. Although not legally binding, the trustees will take into account the deceased's wishes when exercising their powers, unless there are good reasons why they should depart from them. These can be set out in a separate letter which accompanies the will.

Appropriate assets

If a couple jointly own property, it should be owned as tenants in common rather than as joint tenants. This is so the deceased's share passes into the trust contained in their will, rather than automatically to the survivor. It is a simple step to sever an existing joint tenancy and convert it into a tenancy in common.

Tax implications

1 IHT

The Life Tenant is treated as if he or she owned the trust property for the purposes of IHT.

The assets passing to the trust will qualify for the spouse exemption for IHT on the testator's death. If the trustees distribute capital to the ultimate beneficiaries during the Life Tenant's lifetime, this will be treated for IHT in the same way as if the Life Tenant

had made a gift. If the Life Tenant survives seven years from the date of the distribution, there will be no IHT liability. The trustees should seek professional advice before making any distribution.

Where a surviving spouse or civil partner dies after 9 October 2007 then to the extent, if any, that the IHT-free amount has not been used on the death of the first spouse or civil partner, the survivor's IHT-free amount can be increased. A life interest trust in favour of a surviving spouse does not use any of the testator's IHT free amount, ensuring that as much as possible is available to transfer to the estate of the surviving spouse on their eventual death. An additional residence nil rate band may also be available for estates where death occurs on or after 6 April 2017 and a share of the deceased's residence is left to lineal descendants. The allowance is worth £175,000 in the 2022/23 tax year. Again, if unused on the first death, this allowance is transferable between spouses or civil partners. However, the trustees should take professional advice as soon as possible after the first death to ensure that the residence nil rate band is not lost, if available.

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.

2 Capital Gains Tax (CGT)

The trustees will be liable to CGT currently at 20% (but at 28% on residential property if private residence relief is not available) in respect of any gains exceeding the trustees' available annual exemption (a maximum of £6,150 in 2022/23). If available in relation

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to the Life Tenant, Business Asset Disposal Relief (previously known as Entrepreneurs' Relief) will reduce the rate of CGT to 10%.

On the Life Tenant's death, the base value of the trust assets will be uplifted to their then value without any CGT charge. This uplift wipes out any unrealised gains.

Should any beneficiary become entitled outright to trust assets, this will be treated for CGT purposes as a deemed disposal by the trustees. If that happens after the Life Tenant's death there will be no CGT charge as explained above, but if that happens while the Life Tenant is still alive, there will be a CGT charge on gains accrued up to that date. This includes the situation where the trustees decide to distribute capital to one or more of the ultimate beneficiaries.

3 Income Tax

The trustees are generally subject to income tax at the basic rate, presently 20%, but pay tax at 8.75% on dividends. The trustees are not eligible for any personal or dividend 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 the additional tax. A Life Tenant who is a non-taxpayer may reclaim tax previously paid by the trustees.

Administration

A Life Interest Trust needs to be properly administered. This usually involves the trustees registering with HMRC's online Trust Registration Service, 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 in a will for a surviving spouse or civil partner can provide an opportunity to allow the survivor to benefit from all of the assets which the couple presently enjoy between them, while protecting the first to die's assets for his or her ultimate beneficiaries.

Disclaimer

This information sheet is written as a general guide. As any course of action must depend on your individual circumstances, you are strongly 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 2022.

If you require further information, please contact Simon Mitchell, Mark Politz, Nicola Plant or Una Angus on 01892 510000 or by email at:

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