



Life Interests and Rights of Occupation

What are they?

First, some definitions:

Tax Definitions

Interest in Possession (IIP) – when a beneficiary has “a present right of present enjoyment in the net income of the Trust property without any further decision of the trustees being required”.

Immediate Post Death Interest in Possession Trust (IPDI) – when an IIP begins immediately after the death of the person who has created the trust in their Will.

Trust Definitions

Beneficiary – the person who is entitled to benefit in some way from assets within a trust

Flexible Life Interest Trust – A Life Interest Trust where the trustees are given powers to advance capital from the trust to beneficiaries, including the Life Tenant, during their lifetime.

Life Interest Trust – where a beneficiary is given an interest in trust assets for their lifetime, usually the entitlement to receive income, and/or live in a property owned by the trust.

Life Tenant – the beneficiary entitled to receive lifetime benefits from a Trust.

Remainderman – the beneficiary who will receive trust assets after the Life Tenant has died.

Right of Occupation – a right to live in a property for a specified time, or for the beneficiary’s lifetime, but usually subject to conditions.

Most Life Interest Trusts are created by Will. There are certain limited circumstances where an Interest in Possession Trust can be created outside of a Will but these are not considered here.

Life Interest Trusts are most commonly used to create and protect interests in a property. For example, a husband owning the family home may want to make sure that his wife is able to remain living in the property after his death, even though the house itself has been left to their children. The husband’s Will would create a Life Interest Trust or Right of Occupation for his wife, so that she can live in the property for as long as she needs. The Will would then provide that the property passes to the children.

A full Life Interest Trust would arise if the husband’s Will provided that his wife should benefit not only from the right to live in their family home, but also from the income generated if the property is sold and the proceeds invested.

The wife would be the Life Tenant of the Trust, entitled to receive a benefit from the Trust for the whole of her lifetime.

For tax purposes, the Life Tenant has an Interest in Possession. The implications of this are outlined below. Where the life interest in the trust begins immediately after the death of the person creating the trust then it is called an Immediate Post-Death Interest in possession trust (IPDI) by H M Revenue and Customs.

An Interest in Possession Trust can also arise where a beneficiary is left a Right of Occupation. This is a right to live in a property, sometimes for life, but more often for a shorter period. Such trusts will often end when the beneficiary leaves the property for whatever reason, or remarries. If the property is sold, the beneficiary will not be entitled to receive the income from the invested proceeds, so the trust is not a full Life Interest Trust. However the tax treatment of the trust is very similar to that of a full Life Interest Trust.

Tax Treatment

Income Tax

Often, IPDI Trusts do not generate any income because the only trust asset is a house in which the Life Tenant lives. However, the house may be rented out, or sold and the proceeds invested to produce an income for the Life Tenant.

Income received by the Trust should strictly be declared by the Trustees. Currently dividend income (from shares) will be taxed at 8.75% while all other income is taxed at 20%. The Trustees do not qualify for a dividend allowance or savings allowance.

Often, trust income will be paid direct to the Life Tenant without passing through the hands of the Trustees. In this case, the Life Tenant may declare income received direct by them on their own tax return and the Trustees would not include it on the Trust tax return.

Capital Gains Tax

The trustees are a separate entity for Capital Gains Tax purposes and are liable to pay tax on any gains they make over and above the trust's annual allowance. The annual allowance for trustees is half of that of an individual – currently (2022-23) £12,300 (£6,150 for trusts).

If a Life Tenant of the trust is occupying a property owned by the trustees then the trust can mitigate Capital Gains Tax that may arise on the sale of the property by using the main residence relief provisions.

Any investments owned by the trustees should be carefully managed to reduce this tax burden. Any transfer of an asset out of the trust may give rise to a liability if there has been a substantial gain prior to distribution.

On the Life Tenant's death any assets owned by the trust at that point are revalued for Capital Gains Tax so that there is no gain or loss to the trustees.

From April 2016, Capital Gains Tax rates vary depending on the nature of the asset disposed of. Residential Property is taxed at 28% while other chargeable assets are taxed at 20%.

Inheritance Tax

Assets held within an Interest in Possession Trust are treated for Inheritance Tax purposes as if they belong to the Life Tenant. If the trust is brought to an end during the Life Tenant's lifetime so that the

trust assets can be paid to other beneficiaries, the Life Tenant is treated as having made a Potentially Exempt Transfer (PET) for Inheritance Tax, equivalent to the capital value of the trust. If the Life Tenant dies within 7 years of the termination of the trust, the PET will be aggregated with their own estate for calculation of Inheritance Tax.

If the Life Tenant's interest is brought to an end during their lifetime but the trust assets remain held on discretionary trusts, the Life Tenant will be deemed to have made an immediately chargeable transfer for Inheritance Tax and the trust will pay tax at a rate of 20% on the value of trust assets exceeding the Nil Rate Band (currently £325,000 in 2022-23). The subsequent death of the former Life Tenant within 7 years of the termination could give rise to a further Inheritance Tax charge.

If the trust comes to an end on the death of the Life Tenant, again the capital value of the trust will be aggregated with the Life Tenant's estate to calculate Inheritance Tax due. If the value of the trust and the estate together exceed the Nil Rate Band tax will be due at 40% on any excess and this will be apportioned between the trust and the estate.

The trustees and executors can make use of the usual exemptions (eg, where trust or estate assets pass to a surviving spouse or to charity), and the transferrable nil rate band rules (where the Life Tenant is a widow or widower), to reduce the tax payable.

During the lifetime of the Life Tenant, the Trust is not subject to 10 yearly charges or charges when an asset leaves the trust, unlike the tax treatment of Discretionary Trusts.

Flexible Life Interest Trust reverting to Discretionary Trust after death of Life

Tenant

Some trusts are set up so that on the death of the Life Tenant, the trust assets remain held in discretionary trusts for a range of beneficiaries. It is then up to the Trustees to decide which beneficiaries receive trust assets, and when this happens.

In this case, there will be ongoing tax consequences, particularly for Inheritance Tax. For full details please see our information sheet on the taxation of Discretionary Trusts.

If the trust is wound up after the death of the Life Tenant, then the assets distributed will be subject to an Inheritance Tax assessment and an exit

charge may be payable if the value of the Trust exceeds the Nil Rate Band. Under current rules, the maximum tax rate applicable to the exit charge would be 6% of the value of any assets exceeding the Nil Rate Band.

Disclaimer

This Fact Sheet has been prepared to provide you with basic information. It is not to be treated as a substitute for getting full and specific advice from Wards.

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