STUDY ROOM

Flexible life trusts can save families money – even when they at first believe they would not face inheritance tax, as **Bob Cullen** explains

This is not a comprehensive technical treatise on flexible life interest trusts (FLIT) but it shows how they can save inheritance tax even sometimes where it seems there is no liability.

A FLIT usually starts at first death as a life interest trust for a surviving spouse or partner. At second death it becomes a discretionary trust, which does not belong to the beneficiaries personally so is not part of their estate. Beneficiaries may take their inheritance as a loan or series of loans repayable to the trust, usually at their death. They may take their inheritance, spend it, then pay it back to the trust, incurring no inheritance tax (IHT) liability.

They have had their cake, they have eaten it and returned it to the cake tin to be eaten again by their children. The trust can last up to 125 years. There are periodic and exit charges, which are minimal compared to IHT.

CASE STUDY

For simplicity, calculations are based on all deaths occurring in the tax year 2020/2021. The personal nil rate band used is £325,000 and in each case it is transferable to the surviving spouse or civil partner. The residential nil rate band is £175,000 and we shall assume there is equity to cover it and it is transferable to the surviving spouse.

All parents have two children and an estate worth £750,000, comprising property valued at £450,000 and other assets totalling £300,000. Each child mentioned has a spouse and a joint estate worth £800,000. Each child and each spouse inherits £375,000 from their respective parents.

The total allowances are £1,000,000 at second death in that tax year and the estate is worth £750,000, so no IHT is payable. They ask their financial adviser if they need to be concerned about IHT. Their adviser says no.

The client's children each have a joint estate with their spouse of £1,550,000 after receiving their inheritances. Their joint IHT allowances amount to £1m, leaving tax payable on £550,000 of the £750,000 they inherit. This results in a total loss of £440,000, paid in tax by the families. That is a lot of money to lose when all the parents believed that IHT would not be payable.

Yet it is the addition of the parents' money to the children's estate that created the problem. So, although IHT is paid from the children's estates, it is really their parent's estates on which the tax is being paid and where the solution is best applied.

Let's look at a FLIT being set up in all of the parents' wills. At first death the entire estate of the first to die including their share of their property (ownership is '*tenancy in common*') goes into the FLIT. As nothing happens until first death, there are no restrictions on their rights over their assets during their lifetime.

After first death the survivor has a full life interest in the estate, including automatic right to all income and can have access to capital. It is an interest-in-possession trust under HMRC rules so the nil rate bands (personal and residential) are transferable.

At second death, it automatically becomes a discretionary trust and the estate can go straight into a discretionary trust. While the trustees have power to combine the trusts, keeping them separate means each trust has its own IHT threshold.

As a FLIT becomes discretionary at second death, retaining the property in trust means it does not pass to qualifying beneficiaries on death. The residential nil rate band (RNRB) is lost and £40,000 tax is payable on the estate of each set of parents. This is because without the RNRB the parent's estate exceeds the joint personal nil rate bands of £650,000 by £100,00 and IHT is 40%. However, that is avoidable.

A deed of variation could remove the property from the trust, so it passes at second death, saving £40,000 on the parents' estate. However, this can be an expensive mistake as it adds half of the property value to the estate of their children. As both they and their spouses are in similar positions as beneficiaries of their respective parent's estates, this adds £450,000 to the estate of each of the beneficiary's families, taking each family £250,000 over their IHT threshold and causing an IHT bill of £100,000.

Some like to see a protective property trust in the wills for the property instead of including it in the FLIT. This affords some protection but causes it to pass at second death with the same potential result. Assuming the property is in the FLIT, I would propose the following:

At second death, sell the parent's property and arrange a deed of variation. Pass £100,000 of the proceeds of sale to the beneficiaries so that it passes at death, saving that part of the RNRB.

PASSING IT ON

Place the remainder into the discretionary trust. If the children and their spouses do this on their respective parent's estates, the estates of the children increase £100,000. It would save the £40,000 tax on their parents' estates without increasing their estates beyond their allowances of £1m. **Under those circumstances, no IHT is payable – giving a potential total saving of £440,000 for the two families.**

FLITs can save a lot more but it is not just a case of 'set it and forget it'. There should be periodic reviews of current legislation plus professional advice at appropriate times.

If the parents' estates are subject to IHT at their death, these trusts are even more important to guard against a 'double dip' by HMRC, where assets are taxed again at 40% as part of the beneficiaries' estate.

FLITs also help protect family assets following a bankruptcy or divorce. Trustees can have the power to set up further trusts with discretion over their terms. The trustees can end the trust and appoint out the money if legislation or the family situation makes it appropriate, or it can continue to run for up to 125 years.

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