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Flexible Life Interest Trusts

What are they?

A Life Interest Trust usually arises when a beneficiary is left a lifetime interest in relation to assets contained in a deceased person's estate. This normally means that the beneficiary is entitled to receive income from the trust, for life, but they are not entitled to receive capital. The beneficiary with the interest is called the 'Life Tenant'. The Life Tenant may also be identified as the 'Principal Beneficiary'. After the Life Tenant's death the assets in the trust will pass to other beneficiaries identified in the trust deed.

A Flexible Life Interest Trust provides the trustees with the power to pay trust income, and often trust capital to the Life Tenant. The trust may provide that the Life Tenant can live in a property owned by the trust rent free and include powers for the trustees to sell any such property and buy an alternative property for the Life Tenant to live in.

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).

A Flexible Life Interest Trust can provide legal protection for the Life Tenant against any other beneficiaries of the trust, and vice versa. A Statement of Wishes can also be used to inform your trustees as to how you wish the trust assets and income to be used and distributed.

Tax Treatment

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 their annual allowance. The annual allowance for trustees is half of that of an individual – currently (2021-2022) £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 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.

In an IPDI trust or a life interest trust created before March 2006, 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.

Capital Gains Tax is payable at a flat rate of 20% or 28% if there is a residential property, but this is subject to change by the Government.

Income Tax

The Life Tenants will have a right to income as it arises and this will usually mean that income is mandated to them (paid direct automatically). Such income would be declared on a Life Tenant's own tax return and taxed accordingly.

Some income may still have to be declared by the trustees, for example non-mandated foreign income, accrued income on gilts and deeply discounted securities. The trustees may have to declare this income and pay tax on it at the rate applicable to trusts (currently 38.1% for dividend income and 45% on other income).

Inheritance Tax

Assets held within the 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, 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 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 (currently £325,000) 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.

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

If you require further information, please contact Mary Harty on 0117 9292811 or by email at: mary.harty@wards.uk.com

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