Beneficiaries paying premiums under protection policies held in trust

Synopsis: Many will see merit in adult beneficiaries paying premiums under IHT providing protection plans. The tax implications are considered here.

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With the increased difficulties associated with lifetime giving, the qualities of a simple (probably joint life last survivor) policy held in trust to meet the inheritance tax (IHT) liability are not inconsiderable.

One of the many benefits that this solution delivers is the ability for the taxpayer to leave his or her (or their) life unchanged – save, of course, for the outflow of premiums. Although, even this financial disruption could be minimised if the persons who would benefit from the policy (say the children) paid, or at least contributed towards, the cost of cover. Many “would be” beneficiaries may see this as “only fair”, especially when they are of an age to be earning sufficient to make such a contribution to cost.

This contribution could, somewhat crudely, be expressed as a payment of tax in instalments – admittedly in advance. This advance payment plan could carry a significant financial (if not emotional) bonus on the death of the life/ lives assured.

Insurable interest with protection plans cannot, of course, be ignored but insurable interest, strictly speaking, needs only to be proved at outset. This could mean that the policy could be initially effected by the life/ lives assured on an own life “in trust” basis. The life insured having paid the first premium, the beneficiaries could take over premium payments. Before the new trust alignment rules were introduced with effect from 22 March 2006, this strategy would have had no potentially adverse IHT consequences.

The beneficiaries (save for the first premium) would have been contributing to a policy held in trust for their benefit. The trust is likely to have been either a bare trust for the “paying” beneficiaries or a flexible trust under which the “paying” beneficiaries had the interest in possession. The policy will have been in the payer’s estate by virtue of the interest in possession or absolute interest. They will, by virtue of the premium payments, have been making a disposal from which they could benefit, but it will have been either a gift to themselves (and so no gift) under an absolute trust, or sheltered from a double charge to tax where the trust was one under which they had an interest in possession. This would mean that the value of the trust property would not be included twice in the estate of the settlor, i.e. by virtue of the gift with reservation provisions and by virtue of the capital value supporting the interest in possession being deemed to be included in the estate of the settlor.

And this position would not be changed after 21 March 2006 for a pre-Budget 2006 trust policy, provided the beneficiaries were not changed on or after 5 October 2008 (other than as a result of the death of a beneficiary) or the settled property added to, other than as a result of the continued payment of premiums to

the pre-Budget trust or any action taken as a result of the exercise of an option incorporated as part of the policy terms – an "allowed variation" under the legislation.

So how about post-Budget 2006 trusts?

The premium payments will not be gifts if the policy is held in trust for the absolute benefit of the payer but would be if the trust is other than a bare trust. In these circumstances though, the premiums are likely to be exempt. Nonetheless, it will be necessary to seriously consider the impact of the discretionary trust regime in such cases.

It would seem that the policy value would be included in the taxable estate of the payer under the reservation of benefit rules and it would also be subject to the discretionary trust regime. At a superficial level, this seems like a very good reason not to pursue this method of paying premiums. But is this a hasty conclusion?

The double tax regulations would be helpful to prevent a double charge in respect of any charge to IHT that could arise on the death of the payer, by virtue of the gift with reservation provisions and a charge arising by virtue of the payer's death within seven years of making a contribution to the plan by way of premium – which will probably be exempt anyway. However, on the payer's death, the value of the settled property would be included in their estate under the gift with reservation (GWR) provisions.

However, this is no worse than what the position would have been under the pre-Budget 2006, where, on the payer/ beneficiary's death, the policy value (or a portion of it) would have been included in that person's estate by virtue of their interest in possession in it.

Under a post-Budget 2006 flexible or discretionary (i.e. non-bare) trust, though, there will also be the periodic and exit charges to consider. However, this would be the case, even if the life/lives assured (the original settlor(s)) paid the premiums under such a trust.

The fact is that all non-bare trusts are afflicted with this challenge. In practice, in most cases (save for the serious ill health of the life assured at the time of the periodic charge, the holding of an undistributed substantial sum assured at that time or, in the case of a non-term assurance, the payment of substantial premium), there should not be a substantial risk of a charge arising in any event. And, if there were, well, there's always Rysaffe – provided, of course, the risk of potential charges is anticipated when the policy trusts are established.

Finally, it may be more likely that someone paying the premium under a policy would be happy for (and may even require) the trust to be in non-flexible (absolute) format for their benefit. The policy would, of course, form part of their taxable estate, but the periodic and exit charges would be avoided.

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