IHT implications of life policy trusts where the settlor cannot benefit

Synopsis: Excluding business trusts, reversionary trusts, carve-out trusts and any special inheritance trusts.

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Premium payments

Pre-22 March 2006 plans…

Where a policy is held subject to a trust under which the settlor cannot benefit, premium payments under both regular and single premium policies will constitute transfers for inheritance tax (IHT) purposes (although regular premium payments will often fall within the normal expenditure out of income exemption).

To the extent that premium payments made into a pre-22 March 2006 trust policy are not exempt, they will constitute potentially exempt transfers (PETs) (assuming the trust is not a discretionary trust) if they are paid to the trustees or to the extent that they increase the value of the trust fund. However, to the extent that a premium payment does not increase the value of the trust fund by the same amount as the premium (e.g. in the early policy years when there is little or no surrender value) the transfer will not be potentially exempt. In such cases, it is advisable to gift cash to the trustees for them to pay the premiums to the life company as a direct payment will not cause the premium to "become settled property".

It should be noted that FA 2006 allows the settlor to continue to pay contractual premiums under a pre-22 March 2006 trust policy without bringing the trust into the new IHT regime.

HMRC have confirmed that the payment of premiums on or after 22 March 2006 will continue to be treated as PETs if they are made by an individual, whether the payment is made direct to the insurance company or to the trustees in the first place, who use it to pay the premiums. Where the payment is made to the trustees who then pay the premiums, they also agree that the two payments could be regarded as together comprising a disposition by the transferor by associated operations which is to be treated as a PET.

Note that the above was a concession granted to pre-22 March 2006 policies only.

Only if beneficiaries are changed after 5 October 2008 (other than as a result of the death of a beneficiary) or the policy is varied (other than as a result of an ‘allowed variation’) will the trust fall to be taxed under the relevant property regime with premiums taxed as chargeable lifetime transfers to the extent that they are not exempt.

Premiums paid under most business trusts are unlikely to be gifts if paid in a commercial context.

Premiums paid under non-pension policies subject to discretionary trusts will constitute chargeable transfers.

Post-21 March 2006 plans…

Premiums paid under bare trusts (i.e. non settlements) will be exempt or PETs. However, the PET treatment is available only to the extent that the value of the policy in the estate of the beneficiary is increased. Value in this context means the open market value and is a matter for HMRC's Actuarial Team to consider.

If the amount of the premium paid direct to the insurance company is more than the increase in the value of the policy, the excess will be an immediately chargeable lifetime transfer (CLT) (subject to any other available exemptions).

This means that if the protection policy has no value, the PET treatment will not apply if premiums are paid directly to the life office.

To avoid the premiums being treated as CLTs the donor should make payment to the trustees (which will then increase the value of the trust fund and so the value of the beneficiary's estate) for the trustees to pay the premiums. Premiums paid under all other trusts will be CLTs to the extent that they are not exempt. Whether tax is payable will depend on whether, and if so to what extent, the value of the transfer exceeds the transferor's nil rate band. A return to HMRC Inheritance Tax on form 100a will be necessary if the total of CLTs made in any seven-year period exceeds 80% of the nil rate band (i.e. currently £260,000).

Transfer of an existing policy into a trust

When an existing permanent life assurance policy is made subject to a trust the value of the transfer for IHT purposes is measured by reference to the premiums paid to date and the market value (usually the surrender value), whichever is the greater.

In the case of a term assurance with no cash surrender value, unless the life assured were in serious ill health at the time of the transfer, there would be no transfer of value since the value of premiums paid is ignored. However, HMRC are likely to measure the value of the policy by reference to the sum assured (possibly discounted) if at the time of the transfer the life assured is in serious ill health (i.e. in practice, if death from natural causes occurs within two years of such transfer).

Any transfer to a bare trust will be a PET to the extent it is not exempt.

A post-21 March 2006 transfer to other than a bare trust will be a CLT to the extent that it is not exempt. Whether IHT (and/or an HMRC 100a return) is due will depend on the value of the policy transferred.

Periodic and exit charges – non bare trusts

If the policy trust is a discretionary trust or a post-21 March 2006 trust that is not a bare trust, there is a possibility of ongoing periodic and exit charges under the relevant property regime.

Payment of benefits

When the death benefit or maturity value becomes payable to the trustees, no IHT liability will normally arise at that time. If the benefits are paid to specified beneficiaries under a bare trust or to the interest in possession (IIP) beneficiaries (in appropriate shares) under an 'unimpaired' pre-22 March 2006 IIP trust there will be no IHT charge.

If the trust is discretionary (or otherwise treated as a relevant property trust for IHT) and the trust fund is above the nil rate band available to the trust, some IHT liability may arise when the benefits are irrevocably appointed to the beneficiaries under the trust (an "exit charge").

Pension trusts under registered schemes are usually set up on a discretionary basis. However, the legislation provides relaxed tax rules for such trusts and discretionary pension trusts do not suffer from the periodic and exit charges to IHT as long as the death benefit is paid to the beneficiaries within two years of death (section 151 IHT Act 1984). These provisions are extended to term assurance policies issued under personal pension scheme arrangements.

Changes of beneficiaries

A change of beneficiary will only have potential IHT implications in the case of IIP trusts established before 22 March 2006.

In such cases, a change of beneficiaries will result in a transfer of value taking place from the old beneficiary to the new one. Where the new beneficiary becomes absolutely entitled to the appointed fund, this will be a PET. If the new beneficiary does not become absolutely entitled, the 'old' beneficiary will be making a CLT and thereafter the trust will become subject to the relevant property regime.

Further, if the 'old' beneficiary remains within the class of potential beneficiaries following the appointment, the CLT will also be a gift with reservation of benefit. Transitional provisions applied where the interest was changed prior to 6 October 2008.

Death of default beneficiary

Power of appointment, IIP, trusts executed before 22 March 2006...

Under a typical flexible trust with power of appointment, a default beneficiary will be entitled to income - such a trust would be an IIP trust.

The terms of the trust will determine what happens to the income entitlement in the event of the death of the default beneficiary. In most cases where the beneficiary is simply named and nothing else is said, as a general rule, the income entitlement would follow the deceased to their estate, and then to whoever benefits under their Will or intestacy.

However, in the case of a flexible, power of appointment trust, the trustees could make an appointment in favour of another potential beneficiary.

Alternatively, the trust itself may provide for what should happen in the event of death of a default beneficiary.

For example, it is relatively common where there is more than one default beneficiary, for the trust, if subject to English law, to provide that they will benefit as joint tenants, which will mean an automatic transfer of the deceased's right to income to the surviving beneficiary/beneficiaries.

Alternatively, the trust may provide for the income right to go to a specified other person on a named default beneficiary's death, e.g. their children in equal shares. It may be, for example, that the right is to income for life with remainder to a specified person or persons. If there is no such survivorship provision, then the right to income would follow the beneficiary into their estate to be dealt with either specifically in their Will or under intestacy.

There are two separate issues to consider on the death of a beneficiary entitled to income: firstly, the question who should become entitled to income under the terms of the trust; and, secondly, a possible IHT liability. As discussed, it is important that these two issues are treated separately, otherwise confusion arises.

The first non-tax issue is who the new default beneficiary is. In the absence of any specific provision, it will be the person or persons entitled to the interest under the deceased's Will. It should always be recommended that in the event of the death of the default beneficiary the trustees of the trust or the settlor, depending who is the Appointor under the trust, consider making a fresh appointment consistent with the terms of the trust if the new default beneficiary is not the person they desire.

As the right to income under this type of trust is generally always subject to the trustees' power of appointment, i.e. it is defeasible, you would not normally find any specific provisions in the income beneficiary's Will dealing with this. This means that normally the right to income would pass into the residue of the estate to be dealt with under the Will or intestacy. There is a possibility that the beneficiary entitled to the residue under the Will or intestacy could be an excluded beneficiary under the trust. This would include a situation where the beneficiary under the residue is the spouse/civil partner of the deceased beneficiary and that spouse/civil partner is also the settlor of the trust, who, as settlor, is specifically excluded from all benefit under the trust. This could also happen in other circumstances.

As such an interest could not pass under the Will, a partial intestacy would arise. In such a situation, one would have to look at the next available class of beneficiaries under intestacy so that eventually you would arrive at a beneficiary who will inherit the right to income and who is not offensive to the terms of the trust. Of course, this may still not be a beneficiary that the trustees of the trust (or the settlor if still alive if they are the Appointor under the trust) may want to be the default beneficiary. In such a case, if the Appointor exercises the power of appointment, the beneficiary under the Will/intestacy will be treated as making a PET in favour of the new beneficiaries, appointed by the Appointor. It should be remembered that in all cases any appointment under the trust will only be made by the Appointor under the trust (settlor or trustees) - it is nothing to do with the legal personal representatives (LPRs) of the deceased.

The LPRs of the deceased would only be relevant if the deceased was also the sole trustee of the trust (unlikely), as on death of the sole trustee, their LPRs are the new trustees. Obviously, if the deceased beneficiary was also a trustee (but not sole trustee) it will probably be necessary to appoint a new trustee in their place - such an appointment would be made by the person who has power to appoint trustees under the trust.

As far as the IHT treatment of IIP trusts is concerned, the value of the trust fund underlying the right to income is treated as being in the estate of the default beneficiary. If there is only one default beneficiary, the value of the trust fund is treated as being in their estate for IHT purposes (if there is more than one beneficiary, the same applies to the appropriate proportion of the trust fund). To calculate any IHT liability, the value of the trust fund will be added to the beneficiary's estate and any liability in respect of the trust fund would have to be settled by the trustees.

A change of beneficiary arising as a result of the death of an IIP beneficiary will not trigger the relevant property trust regime. However, any appointment by the Appointor to another beneficiary, will.

Post-21 March 2006 trusts...

The death of an IIP beneficiary under a post-21 March 2006 trust will not give rise to any IHT as it will not constitute a taxable event under the relevant property regime.