Case study - do you know the consequences and potential problems of paying life policy premiums?

Synopsis: Where premiums are not exempt, what is the impact on the client's inheritance tax position?

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Where clients use life cover to pay their inheritance tax (IHT) bill you need to know how to treat their premiums and what the consequences are where the premiums are not exempt.

There are generally two different types of life cover plans that clients will use for IHT planning. They are level term assurance and whole of life plans.

Level term cover

Term assurance is the most basic form of life cover offering a lump sum payment in exchange for a regular premium for a set number of years. If the person covered survives to the end of the term, there is nothing payable and the cover ends.

Generally used to cover the IHT payable on large gifts or to replace the tax lost where the gift uses up the client's nil rate band.

Whole of life plans

Whole of life cover is generally a unit linked type of life cover that does not have a specific term attached to it and therefore pays out a sum insured on death of the person covered. As there is no term attached it will either end on death or surrender by the plan owner.

Generally used to cover the IHT payable on death of clients due to their estate being over the available nil rate bands and residence nil rate bands.

Trusts

Normally life cover is written into trust using either an absolute trust or a discretionary trust.

Absolute gift trusts

This is a trust with a fixed beneficiary chosen at outset which cannot be changed, no matter the circumstances. The beneficiary can demand the trust fund when they reach age 18 (16 in Scotland) and the trustees, by law, must tell them that a trust fund exists and give them access.

Discretionary gift trusts

Under a discretionary trust, it is up to the trustees to decide who will benefit and when they will benefit from the trust fund.

As long as the beneficiary is in the class of beneficiaries, the trustees can allocate funds to them.

Premiums

The premiums paid to fund a life cover plan which is written into trust are transfers of value for your clients. If they are not exempt, they will either be potentially exempt transfers (PETs) or chargeable lifetime transfers (CLTs).

The annual IHT exemption of £3,000 per person can be used against premiums paid to fund a life policy. Otherwise, premiums can be paid out of the client's income and, as long as these do not affect the client's normal standard of living and are regular in nature, they will generally qualify for the normal expenditure out of income exemption.

However, do not forget that the normal expenditure out of income exemption is only tested on death. Therefore, where your clients take out a jointly owned plan you need to reassess the position on first death. The premiums, generally, will remain the same throughout the lifetime of the policy but in some circumstances the surviving client's income may not be large enough to cover the full premium. This means that they may now be chargeable if the normal expenditure out of income exemption cannot be claimed.

PETS

If clients place their life cover plan into an absolute trust the premiums paid into the trust will be PETS if they are not covered by exemptions.

PETs drop out of the client's IHT timeline after seven years. However, where there is a regular premium payable until death, there will always be at least seven years' worth of premiums in the client's IHT calculation.

PETs use up the client's nil rate band and are deducted in chronological order. This means you ought to be aware of these premiums when calculating the IHT liability on your client's estate.

It is very common for clients to set up a direct payment to the product provider to fund their life plan. However, where an absolute trust is used these will be classed as CLTs. The reason being is that the definition of a PET is that it must increase the recipient's estate which it does not if the premiums are paid directly from the client to the product provider. In these circumstances a trustee bank account should be set up to receive the premiums before they are used by the trustees to pay the product provider.

CLTs

If clients place their life cover plan into a discretionary trust the premiums paid into the trust will be CLTs if they are not covered by exemptions.

CLTs generally drop out of the client's IHT timeline after seven years. However, where there is a regular premium payable until death, there will always be at least seven years' worth of premiums in the client's IHT calculation.

To avoid an IHT entry charge, each individual can only pay £325,000 into discretionary trust in a seven-year rolling period. If they exceed this limit an entry charge of 20% is payable to HMRC. This means if your clients have a large life cover plan in place and the premiums exceed their cumulation they will have an entry charge to pay each time they breach their £325,000 limit.

You ought to check with clients before doing any IHT planning with discretionary trusts and ensure that you include any premiums payable to life cover plans that are not covered by their IHT exemptions. You may need to factor in future premiums that will be paid in order that they do not breach their seven-year rolling limit.

Case study

Albert wants to set up a discretionary trust for the benefit of his grandchildren to help them get on the property ladder. He wants to use £325,000 of the cash he has in the bank to invest in the trust.

He has a large estate, partly due to the value of his property of £2m, which will be subject to IHT on his death. Albert is a widower who inherited all his wife Elsie's estate when she died.

He set up a whole of life policy with Elsie more than seven years ago, which is payable on second death. The premiums are £20,000 payable each year and funded from withdrawals from his investment bonds.

Albert lives off his State Pension and tops this up with withdrawals from his sizeable investment bonds. He gifts £1,500 to each of his two children yearly which they use to top up their ISAs.

His adviser has informed him that, as his whole of life premiums are funded from investment bonds this is treated as capital and not income. The impact of these premiums means that he can only place £325,000 less seven years' worth of premiums into the trust. Therefore, he can only settle £185,000 into trust as the life policy uses up £140,000 of his CLT cumulation. Otherwise an IHT entry charge will apply.

Conclusion

As you can see, if your clients use life cover as part of their IHT planning it can be problematic if premiums are not covered by any of their IHT exemptions.

You ought to check whether clients have enough income to utilise the normal expenditure out of income exemption, or factor in the premiums, when you are considering advising them to make any additional CLTs.

One alternative to clients paying the premiums and writing the plan into trust is to assign the plan directly to their children instead of into trust. If the children can afford to pay the premiums it means the children become the owners of the plan and can pay the premiums instead of their parents. This saves any PETs or CLTs being created by your clients.

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