Providing for inheritance tax (IHT) on death through life assurance – the basics

Synopsis: How a life assurance policy can be used to insure against the possibility of an IHT liability and what type of policy is appropriate.

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IHT is essentially a tax payable on transfers. For most people, no IHT will become payable until they die and their entire estate passes to non-exempt beneficiaries. Making lifetime gifts can reduce the IHT liability provided the donor survives seven years. However, this course of action is often impeded by the donor's requirement to retain access to and/or control over what is to be given. In these circumstances, life assurance held in trust can deliver an effective solution.

Even where lifetime gifts are possible, life assurance in trust, effected on a temporary basis, may be appropriate to insure against the possibility of an IHT liability (or increased IHT liability) arising as a result of the donor's death within seven years of making the gift.

It is important to understand how a life assurance policy can be used to insure against the possibility of an IHT liability and what type of policy is appropriate.

Fundamentals

- IHT is payable on death at the rate of 40% (or 36% where 10% or more of the net estate is left to charity) to the extent that the estate passing to non-exempt beneficiaries exceeds the nil rate band (currently £325,000). Transferable nil rate band will be available if the first of a couple to die has not used up their nil rate band, potentially allowing the nil rate band of £650,000 on the death of the second of the couple to die.

- From April 2017 there is an additional nil rate band where a residence passes to direct descendants. This was £100,000 in 2017/18 and increased in stages to £175,000 in 2020/21 (and will be frozen at that level until the end of 2027/28) although it will be withdrawn by £1 for every £2 of the value of the estate that exceeds £2m.

- IHT is also payable on chargeable lifetime transfers above the nil (CLTs) rate band. Further IHT will be due on failed gifts above the available nil rate band. Lifetime gifts will be either, exempt, potentially exempt or chargeable.

- Where death occurs between three and seven years of a gift, the amount of IHT (if any) payable on the gift will be reduced by taper relief. The relief is given on a sliding scale so that (broadly) the amount of IHT payable is reduced for those who survive the longest time. Note that because taper relief reduces the tax payable, if the gift in question is within the settlor’s available nil rate band (so that there is no tax payable on the gift itself), no relief will be available.

- Generally speaking, any IHT that becomes due as a result of death, is payable by the executors (or administrators) out of the proceeds of the estate. The exception is where the IHT liability is attributable to a lifetime gift that has become liable to IHT (or additional IHT) as a result of death, in which case the liability will usually be discharged by the recipient of the gift.

- The deceased's personal representatives (the executors in the case of somebody who has died having made a will, or administrators if a person has died intestate) must deliver an account to HMRC of all the deceased's property and pay the tax before a grant of representation can be obtained. This can prove to be a challenge where there is insufficient liquidity in the estate as the personal representatives cannot secure their title without the grant, which they cannot obtain until the tax is paid. This is where a life insurance policy held in trust can be useful.

- Because a trust policy is owned by the trustees rather than the deceased, no grant of probate is necessary to enable them to access the proceeds (provided there is at least one surviving trustee).

Planning

Many clients' wealth will be tied up in illiquid assets (such as the main residence) so that the usual approaches to IHT mitigation (i.e. lifetime gifts) are prohibitive. Alternatively, clients may have liquid assets but may be reluctant to make lifetime gifts because of uncertainty surrounding future income and capital requirements. Consequently, and despite the introduction of the transferable nil rate band and the residence nil rate band, many families will still face an IHT liability on the second death.

A ready source of liquid cash outside of the estate, can provide the deceased's heirs with the funds they need to pay the IHT, obtain the grant of probate, and release the estate and this is where life assurance policies come into their own.

Type of policy and choice of trust

Whole of life policies are the natural contracts for funding for payment of the IHT liability on death. The initial sum assured would be equal to the IHT liability at the time the advice is given but should be kept regularly under review. For most couples (married or registered civil partners) the main IHT liability would arise on the second death and the policy would therefore be written on a last survivor, second death basis for a sum assured equivalent to the IHT liability that would arise at that time.

Where it is desired to put cover in place to insure against the potential liability (or additional liability) arising as a result of a client's death within seven years of making a lifetime gift, a term assurance policy should be considered.

If the gift which is to be covered is a potentially exempt transfer (PET) or CLT that is within the nil rate band available to the donor at the time of the gift, then the term of the policy (for new gifts) would be seven years and the sum assured would be level i.e. not "reducing".

The policy should be written on the life of the donor for a sum assured equal to the difference between their current IHT liability and the reduced liability after seven years i.e. once the gift has fallen out of account.

Where the gift itself is expected to result in an IHT liability in the event of the donor's death within seven years (i.e. because the value of the gift exceeds the donor's available nil rate band), the appropriate policy would then be a seven year term assurance with an initial sum assured equal to the maximum liability but with the sum assured reducing in line with taper relief.

Taper relief provides a percentage reduction in the IHT liability as follows where the donor survives at least three years...

- 3-4 years 20%
- 4-5 years 40%
- 5-6 years 60%
- 6-7 years 80%

This policy is known as a gift inter-vivos plan.

The policy could be written using a discretionary or absolute/bare trust, depending on the client's objectives.

IHT treatment of the policy

The IHT treatment of the policy will depend largely upon what type of trust is used and needs to be considered under three separate headings...

a) Premiums

In most cases, regular premiums paid to a life assurance policy that is written in trust will be exempt under the normal expenditure out of income exemption or under the annual exemption.

In the rare circumstance where a premium is not exempt, the premiums will be PETs* if the trust is an absolute trust; or CLTs, although a lifetime charge to IHT will only arise the if the settlor's cumulative total of chargeable gifts made over the previous seven years exceeds the nil rate band.

*The premiums are normally PETs if paid by the trustees however if they are paid directly to the insurer or they do not increase the value of the absolute trust they will be CLTs.

b) Proceeds

The proceeds of a life assurance policy written in trust will be paid free of IHT to the trustees. There may however in some cases be an IHT exit charge where proceeds are distributed to beneficiaries if other than an absolute or bare trust has been used (please see below).

c) Other occasions of IHT

Unless a bare (or absolute) trust has been used, the trust will be a relevant property trust and so potentially liable to IHT charges periodically every ten years (at a maximum of 6%) and where property is distributed to beneficiaries between ten yearly anniversaries.

The property charged to tax at the ten year anniversary will be the market value of the policy at that time (assuming the life assured is still alive). This is generally the surrender value of the policy, although it could be the amount of the premiums that have been paid into a whole life or endowment policy if that was more than the surrender value. This "premiums paid" basis of valuation does not therefore apply to pure term policies.

Generally speaking, no exit charges will arise in the first ten years of the trust's existence and there would only be a risk of a charge after that if there was a periodic charge at the time of the ten year anniversary preceding the exit of the funds from the trust (and even then only at an appropriate, time based, proportion of the previous periodic charge).

d) Avoiding the periodic or exit charge

As stated, in most cases the risk of there being a periodic or exit charge on a life policy is small, but it does exist for larger policies i.e. those with sums assured in excess of the available nil rate band.

To try to mitigate against this risk, it may be worth arranging the required insurance through a series of separate policies established on different days under separate trusts. This strategy is based on the Court of Appeal decision in the case of *Rysaffe Trustee Co (CI) Limited v CIR, 2003* which confirmed that separate trusts established on different days, even by the same settlor, are not connected or related and can therefore each benefit from their own individual nil rate band.