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LIFE INSURANCE SPECIALISTS

Estate planning matters January 2025

Synopsis: This is the second edition of Estate Planning Matters, designed to provide an insight into topical tax planning issues linked to writing life policies in trust. A number of the proposals made in Labour's first Budget on 30 October 2024 affect inheritance tax and estate planning. These proposals will inevitably create higher inheritance tax liabilities on death and mean that more people will wish to make lifetime gifts. This will create a greater demand for writing life policies in trust to provide funds to meet inheritance tax on a person's death

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ABOLITION OF THE NON-UK DOMICILE TAX REGIME

As previously announced, the Budget confirms that, with effect from 6 April 2025, domicile - a key status for liability to inheritance tax - will no longer be a defining concept for UK tax purposes.

Implications - inheritance tax

As far as the implications for inheritance tax are concerned, domicile will be replaced by long-term residence which exists where a person has been UK resident for at least 10 out of the last 20 years, ending in the tax year before the chargeable event.

Non-UK domiciled spouses of UK domiciled long-term residents will be able to elect to be treated as long-term resident if they are not already. If they do so elect, assets passing between them will be free of inheritance tax.

Trusts (including existing Excluded Property Trusts – see below) will be subject to the relevant property regime (ten-year periodic charges and exit charges) if, immediately before the chargeable event, the settlor is a long-term UK resident. If the settlor ceases to be a long-term resident, an exit charge will arise.

Excluded property trusts are trusts established by a non-UK domiciled person. Provided the trust is invested in non-UK situs assets, the property is currently not in the inheritance tax net – even if the settlor is a potential beneficiary.

The Budget proposals confirm that the gift with reservation rules will not apply to excluded property trusts under which the settlor is a potential beneficiary provided

the trust was set up before 30 October 2024. However, the gift with reservation provisions can apply to trusts created after that date.

Planning

Clients should consider the following planning**...**

- Those who have been long term resident in the UK but are non-UK domiciled will find that from 6 April 2025, their assets - even those that are overseas - will be subject to inheritance tax. For these people, unless they contemplate moving abroad, they could suddenly be facing substantial inheritance tax liabilities on their death. For many such individuals, a life assurance policy effected in trust for the beneficiaries who will suffer because of the inheritance tax payable on death will look to be an attractive option.

- There is a possible window for non-UK domiciles and non-UK deemed domiciles who have been UK resident for more than 10 years to transfer current excluded property (mainly non-UK situs assets) out of their estates before 6 April 2025. This would include transfers to trusts (but the settlor should not be a potential beneficiary under the trust to avoid the gift with reservation rules). From 6 April 2025, trusts will be taxed as a discretionary trust for inheritance tax purposes if the settlor is then a long-term UK resident.

- Clients who, whilst non-UK domiciled, have set up excluded property trusts prior to 30 October 2024, will have a number of important decisions to make before 6 April 2025

FREEZING OF INHERITANCE TAX NIL RATE BANDS

The inheritance tax nil rate band and residence nil rate band will remain frozen, at £325,000 and £175,000 respectively, for a further two years to 5 April 2030. The threshold of £2 million, after which the residence nil rate band is tapered, also remains unchanged

Implications

The nil rate band has been frozen at £325,000 since 6 April 2009 meaning that it will not have changed for over 20 years by 5 April 2030. During this period, the average value of estates has increased significantly. In 2009-10 around 2.7% of estates were liable to inheritance tax with the tax raising around £3.7 billion (adjusted to 2023-24 prices).

Prior to the Budget and the provision to include pension funds in estates on death for inheritance tax purposes, it was estimated that 6.3% of estates would become subject to inheritance tax by 2028-29 with the tax raising £9 billion (adjusted to 2023-24 prices). The inclusion of pension assets in estates from 6 April 2027 (see

below) will mean than there will be a significant jump in the number of estates becoming liable to inheritance tax from 2027-28 and the amounts raised by the tax.

The residence nil rate band has been frozen at £175,000 since 6 April 2020.

Planning

Married couples should ensure that both sets of nil rate bands and residence nil rate bands. People who have been widowed and subsequently remarried should ensure that they make full use of the additional nil rate bands and residence nil rate bands that can be available.

The freezing of nil rate bands and the residence nil rate band for a further two years will mean that even more people will fall into inheritance tax and those already in the net are likely to pay more – especially given the pension changes (see below). This means that there is even more need for individuals to take out life policies subject to trust to help meet potential inheritance tax liabilities.

PENSION FUNDS TO BECOME SUBJECT TO INHERITANCE TAX ON DEATH

Budget proposals and background

New measures are to be introduced which are designed to discourage people from investing in pensions purely to shelter assets from inheritance tax. What follows below is based on the proposals made at the Budget. **These may change following the consultation process which ended on 22 January 2025**. More detailed guidance on how the rules will operate can be expected later this year.

Unused pension funds on death and pension death benefits from registered pension schemes & qualifying unapproved non-UK pension schemes (QNUPS) will form part of the deceased's estate where death occurs after 5 April 2027 and so potentially be subject to inheritance tax charges.

Existing allowances and exemptions (including the spouse exemption) will continue to apply when calculating inheritance tax liabilities. Notwithstanding this, the estates of widows, widowers and other single people or one of an unmarried couple are likely to face significantly higher inheritance tax liabilities on death after 5 April 2027 if the deceased has pension assets.

The provisions are complicated and subject to a consultation process that ceased on 22 January 2025. So, more detailed guidance on how the rules will operate can be expected later this year.

Broadly the main impact of the provisions is that, on the pension member's death, the value of the defined contribution pension fund(s) or death benefits payable at the date of the member's death (including any death benefits paid from a defined benefits scheme) will be added to the value of the deceased's free estate when

calculating inheritance tax liabilities. Any allowances, such as the available nil rate bands etc, will be apportioned between the free estate and the pension scheme(s).

Where pension scheme assets are left to a surviving spouse or civil partner, the inheritance tax spouse exemption will apply and this could defer the payment of inheritance tax on any remaining pension assets until the spouse's subsequent death.

Income tax liabilities may also arise on the lump sum death benefits paid that exceed the lump sum death benefit allowance or are paid on a member's death on or after age 75 or later. In these cases, there may therefore be double taxation which could take the overall rate of tax up to 67%.

The deceased's legal personal representatives (LPRs) will need to correspond with the pension scheme administrators (PSAs) to determine the amount (if any) of inheritance tax payable and how this is apportioned between the free estate (which is payable by the LPRs) and the pension scheme(s) with the PSAs making a payment from the deceased's pension assets.

This means that any pension death benefits payable to the deceased's beneficiaries will not be paid until the pension scheme's share of inheritance tax liabilities have been settled.

Implications

The addition of pension fund values and/or lump sum pension death benefits to the value of a deceased's estate is likely to bring a significant additional number of estates into the inheritance tax net. The inclusion of pension fund assets in the estate of the deceased may also cause a reduction in the entitlement to the residence nil rate band.

Those estates that are already likely to face an inheritance charge on death may face significantly higher inheritance tax liabilities where death occurs after 5 April 2027, meaning that the beneficiaries of the estate and the pension scheme(s) may receive lower amounts than anticipated.

Inheritance tax is payable 6 months following the end of the month in which death occurs. Personal representatives could face a significant increase in work in determining inheritance tax liabilities. The amount of inheritance tax payable on the free estate may also be higher than expected due to the apportionment of the deceased's nil rate band(s) (and any transferable nil rate band) between the free estate and the pension scheme(s).

Many estates may lack sufficient liquid assets to meet the full inheritance tax liability attributable to the free estate, especially as liabilities could be higher than expected due to the apportionment of the nil rate band(s) between the free estate and pension scheme(s).

This means that many estates will miss the 6 month deadline for inheritance tax payments and then become subject to penalties and interest from HMRC for

missed payments. The October 2024 Budget also increased the rate of interest that HMRC can charge on unpaid tax by 1.5% from 6 April 2025. This increases the late payment interest rate to bank base rate plus 4% meaning that, assuming the current bank base rate of 4.75% still applies on 6 April 2025, the late payment interest rate will be 8.75% p.a.

It is hoped that a number of these issues will be addressed during the consultation process.

The spouse exemption

HMRC have confirmed that where the pension scheme death benefits pass to the deceased member's spouse or civil partner, there will be no inheritance tax. There has been some talk of this being a panacea for planning with pension funds on death but this could be a short term view.

Although pension funds passing to spouses would be free of inheritance tax, it should be remembered that this will simply cause the spouse's estate to increase and probably be aggregated with other assets at death owned personally by the spouse and inherited from the pension scheme member. If the surviving spouse was then financially comfortable, he/she could then consider making lifetime gifts or using inheritance tax trust arrangements in order to reduce their taxable estate.

Planning

It is inevitable that for many people who have not spent all of their pension fund, the pension fund value will increase the IHT liability on their death (or their spouse's death if the fund passes to the spouse).

This means that there will be an increase in the need for life assurance written in trust for the beneficiaries under the estate to meet the additional inheritance tax that will then arise. This will provide tax efficient cash that can be lent to the executors to pay inheritance tax. This will also speed up the issue of the grant of probate.

Although these measures apply where death occurs after 5 April 2027, people who are likely to be affected should be considering action now in contemplation of them coming into effect. Such planning will involve drawing cash out of the pension fund and transferring it to the next generation. Cash can be withdrawn in one of two ways – as a lump sum or on a regular basis by using income drawdown.

Tax free cash

Those who have not taken their full entitlement to tax-free cash from a pension fund(s) - particularly those aged 75 or over - could consider taking this now and gifting any amounts not required to, say, family members or a trust. Once the gift is survived for 7 years, it falls out of inheritance tax yet whereas if this amount stays in the scheme it is potentially subject to inheritance tax at 40%. Certain trusts can allow access to an income stream or to capital whilst still keeping the gifted assets outside of the donor's estate.

Decreasing (inter-vivos) term assurance could be established to cover the potential inheritance tax arising on such gifts, with a level 7 year term assurance being effected in trust to cover the additional inheritance tax liability arising on the estate in the event of the donor not surviving the gift by seven years because of the loss of the nil rate band allowance to the lifetime gift.

Drawing income from the pension fund

Those with large pension funds may also wish to draw down additional amounts as income from the pension(s). This can be achieved by taking income drawdown or buying a pension annuity.

On the basis this then gives them surplus income, they could use that excess to meet regular premium payments on policies in trust to pass funds to, say, family members. On the death of the settlor and the payment of the policy proceeds, the recipient family members can then make loan to the deceased's personal representatives to meet inheritance tax liabilities on the free estate. These payments can also be used to 'top up' the amounts received by the beneficiaries to compensate for increased inheritance tax liabilities.

There are conditions that need to be met to qualify for the normal expenditure out of income exemption, namely that...

- The gift must be regular
- It must be made out of income, and
- It must not cause the donor to suffer a reduction in their normal standard of living

It is best to keep records of such payments, preferably completing the form IHT 403 form which the deceased's legal personal representatives use to claim the normal expenditure exemption on the deceased's estate on death.

REFORMS TO BUSINESS RELIEF AND AGRICULTURAL RELIEF

Two main changes have been announced by the Government, both of which take effect from 6 April 2026....

Business/agricultural relief

The benefits of inheritance tax business relief (BR) and agricultural relief (AR) will be severely curtailed from 6 April 2026. Currently, 100% business relief is available, without limit, on the value of a business or interest in a business and on shares in unlisted companies (including AIM shares) and 50% relief is available on controlling shareholdings in a listed company and on personally owned land, buildings and machinery that is used in a business. These reliefs are subject to certain conditions which include that the assets need to have been owned for at least 2 years.

Similarly, 100% AR is available, without limit, for farmland and associated buildings owned and farmed by an individual with 50% relief being available if the land is farmed by someone else.

These reliefs were intended to provide continuity of business and/or farming activities following the death of the owner by, say, family members, without the need to sell some or all of the assets to meet inheritance tax liabilities.

From 6 April 2026, it is proposed that only the first £1million of combined business and agricultural assets eligible for 100% BR and/or AR will receive 100% relief with any excess receiving relief at 50%.

This £1 million limit covers both reliefs (i.e. it is the total for which 100% relief can be claimed for all qualifying business and agricultural assets) and both lifetime gifts and qualifying assets on death.

Implications

Business and agricultural assets in excess of the £1 million allowance will be subject to inheritance tax at, currently, 20% where death occurs after 5 April 2026 unless other reliefs and allowances are available.

The new measures are likely to cause significant disruption to more valuable businesses and agricultural businesses on the death of an owner and could affect the continuity of the business unless the beneficiaries are able to meet the new inheritance tax liabilities that will arise.

Whilst, in a number of cases, IHT can be paid in interest free instalments over 10 years, the inheritance tax will still need to be found to avoid business assets having to be sold or the beneficiaries may be saddled with expensive borrowing.

Planning for the restrictions in business and/or agricultural relief

(a) Making lifetime gifts

Business and farm owners could consider gifting business and/or agricultural assets to family members and/or trusts. Gifts to individuals or bare trusts are potentially exempt transfers and will fall out of inheritance tax once the donor survives for 7 years.

Where one partner of a married couple owns all or most of business or agricultural assets, they could consider gifting sufficient assets to their spouse to enable the spouse to make full use of his or her £1 million business and agricultural relief allowance on their subsequent death.

Such gifts are exempt transfers for inheritance tax and are treated as being on a ‘no gain, no loss’ basis for capital gains tax purposes.

On the first death, the deceased’s assets benefitting from 100% business relief should not be passed to the surviving spouse but to family members and/or a discretionary trust.

(b) Providing for the liability

Life assurance written in trust will become almost essential to fund for any inheritance tax liabilities that may arise on death to allow beneficiaries to inherit a business and/or a farm intact, ensuring continuity of the business. Business owners may find that using a relevant life policy can provide tax-effective life assurance benefits to family members.

Seven year term assurance policies written in trust will be important as a means of providing for the inheritance tax (both on the gift and the estate) that may arise on the death of a donor who has made lifetime gifts of business property as part of inheritance tax planning.

Review business succession arrangements

Owners of non-family businesses who have set up share or partnership purchase arrangements for business succession may need to review the arrangements. Whilst a single or cross option agreement preserves the business relief on death, an inheritance tax liability may arise in the future if the value of the shares, or partnership interest, exceeds £1 million in value and the beneficiaries under the estate are persons other than a spouse. A similar position will arise in relation to a company share purchase arrangement.

To deal with this issue, the parties should take out life assurance in trust for the beneficiaries who will suffer the inheritance tax. This will mean that cash is available more quickly to meet the inheritance tax and make it easier to obtain probate..

AIM stock

With effect from 6 April 2026, shares that are designated as 'not listed' on the markets of a recognised stock exchange, such as AIM shares, will only receive business relief at 50% on lifetime gifts made by, or on the death of, the shareholder. Such shares will not count towards the £1 million limit.

Whilst the investment performance of AIM stock has been mixed, a number of people will have invested in these shares mainly to obtain inheritance tax advantages without taking the risk of investing in totally unquoted shares.

Planning

Holders of AIM shares are likely to face additional inheritance tax liabilities on their portfolios on death after 6 April 2026 following the reduction in business relief from 100% to 50%.

It is likely that most of the clients who already own AIM stock have substantial estates. And because AIM stock previously qualified for 100% business relief, that stock may have been left to the children or to trusts on the investor's death. If that is the case, provided the value of the AIM stock, net of business relief, is less than the available nil rate band, there will be no IHT problems on the investor's death.

But if the taxable value exceeds the investor's available nil rate band, the investor will need to consider planning action in light of the changes.

One such planning tactic will be to cover the inheritance tax liability by effecting life assurance policies in trust for the recipients of the AIM stock on the investor's death.

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