RISK ASSURED
LIFE INSURANCE SPECIALISTS

Pre-owned assets tax (POAT) and life policies in trust

Synopsis: Impact of POAT on different life policy trusts.

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Life policies in trust and POAT

Introduction

A life assurance policy is an intangible asset for the purposes of the pre-owned assets tax (POAT) rules.

For the POAT rules to apply to intangibles (on the basis that the gift has not given rise to a gift with reservation of benefit (GWR)), two conditions in Sch 15 para 8 Finance Act 2004 need to be satisfied...

> (i) there must be a settlement; and
>
> (ii) the settlor would be subject to income tax undersections 622 and 624 to 627 ITTOIA 2005 on any income that arose to the settlement.

This issue has caused some considerable concern. If the settlor is merely a potential beneficiary under the trust who might benefit if the trustees appoint benefits to them, why should the settlor be taxed on the basis that the whole trust fund belongs to them? There is no guarantee that they will benefit and whether they will or not is outside of their control.

In these circumstances, HMRC takes the view that this is 'psychic income'. Its view is that because the settlor *could* benefit from all of the trust fund, they should be taxed as if they actually enjoyed it (at a rate that reflects the likely loss of inheritance tax (IHT)). This approach is on a similar basis to that used by the IHT GWR rules, which state that if a settlor is a potential beneficiary under a trust the whole of the trust property is treated as forming part of their estate.

The amount of the POAT charge

For these purposes, the regulations state that one applies 'the official rate of interest' to the value of intangible assets in question on 6 April each year in order to determine the value of the benefit subject to the POAT.

The official rate of interest has the meaning given to it in ITEPA 2003, s181, and is currently 2.25% (2024/25 tax year). This was also the rate for 2023/24. It was 2% in 2021/22 and 2022/23. It will increase to 3.75% from 6 April 2025. HMRC have indicated that the official rate of interest will be reviewed quarterly from 6 April 2025.

The two conditions in more detail

The two important conditions that need to be satisfied for a POAT charge to apply on a gift of intangibles are mentioned above. Let us now look at these in more detail.

(i) Settlement

The first condition that needs to be satisfied is that there must be 'a settlement of property'. What does 'settlement' mean for these purposes?

Well, a clue may be given by the second limb of the POAT test, which relates to whether the settlor would be taxed under sections 622 and 624 to 627 ITTOIA 2005. This is a clear reference to a settlement in the income tax code. For these purposes, settlement has a very wide meaning as set out in s620(1) ITTOIA 2005; 'settlement' includes any disposition, trust, covenant, agreement, arrangement or transfer of assets.

However, Sch 15 para 1 states that 'settlement' for the purposes of Sch 15 has the meaning given in IHTA 1984, s43. This is of fundamental importance because the IHT meaning of settlement in IHTA 1984, s43 is more limited than that which applies for income tax.

For example, a bare trust is not a settlement for IHT (and therefore not a settlement for the purposes of the POAT rules), yet a bare trust is a settlement for income tax purposes. It is this mixing of IHT meanings and definitions with income tax meanings and definitions which causes considerable confusion in interpreting these rules.

(ii) Sections 622 and 624 to 627 ITTOIA 2005

These are the anti-avoidance income tax rules that state that where a settlor (or their spouse/civil partner) may enjoy any benefit from a settlement, then any income will be taxed on the settlor.

For the purposes of the POAT rules, however, one excludes any reference to the settlor's spouse/civil partner (again to provide correlation with the IHT GWR rules).

The key question is, therefore, can the settlor benefit under the settlement? In many cases this will be a fairly straightforward question. However, there have been a number of tax cases over the years to test this issue in more difficult cases.

Finance Act 2004 amendment

An amendment to Sch 15 para 8(1) of the 2004 Finance Bill at committee stage had the effect of meaning that, for the purposes of interpreting these rules, a trust could consist of a number of separate sub-trusts.

This amendment makes it clear (when different property in a settlement is subject to different trusts) that only the particular property which is 'caught' by para 8 is subject to the charge imposed by Sch 15, and not (where greater) the whole property of the settlement.

Where such sub-trusts exist, it is therefore necessary to test each independently to see if the POAT rules apply. This is a very important point when we come to looking at trusts of life assurance policies.

Life assurance policies and gifts with reservation

The POAT rules can apply to any disposals made since 18 March 1986. An important prerequisite for that application is that the property disposed of is not caught by the GWR rules. The POAT rules in effect come into play where transactions have been established which out-manoeuvre the GWR rules yet still enable the donor to benefit. They therefore act as a second tier of defence to the Treasury.

Over the years, many life assurance policies have been placed into trusts which will now be regarded as settlements for the purposes of the POAT rules. Many of these trust policies legitimately escape the GWR rules, but, because they represent settlements and because, in a number of cases, the settlor can benefit, it is necessary to consider whether the POAT rules will apply.

We now consider in detail below whether the GWR and POAT rules apply to different life assurance trusts.

Special life assurance trusts

Flexible trusts

A trust that is commonly used in connection with life assurance policies is a discretionary trust or a power of appointment (interest in possession) trust (less common since 22 March 2006). These trusts are frequently referred to as ‘flexible trusts’.

The settlor should be excluded as a potential beneficiary because that would give rise to a GWR for IHT purposes. However, the settlor’s spouse or civil partner can be included without a GWR arising and because a life policy is a non-income producing asset there will be no income tax or capital gains tax (CGT) problems for the settlor.

The POAT rules do not bite merely because the settlor’s spouse/civil partner is a potential beneficiary. Therefore, there should be no adverse POAT implications in connection with this trust.

Revert to settlor trusts

For some time it has been accepted by HMRC that a trust, where the benefits of a policy revert back to the settlor at a future fixed date or on a future occasion, will not give rise to a GWR as that right is clearly carved out and ‘kept back’ by the settlor. In effect, the settlor makes a gift of the other benefits under the policy ‘shorn’ of the retained rights which are held on flexible trusts (similar to that described above) and from which he is excluded from benefit.

HMRC has confirmed that, in such circumstances, it takes the view that the different interests in the property can be held in separate sub-trusts. One interest is the settlor’s reversionary interest, which is held on bare trust for the settlor. The other is the remainder of the settled property (which represents the value of the

trust fund should the settlor fail to survive to the reversionary date) and this is held on power of appointment trusts for the potential beneficiaries.

The effect of this is that the POAT rules will not apply because that part of the trust fund under which the settlor can benefit is held on bare trust which is not, for IHT purposes, a settlement. Although the rest of the trust fund is held subject to a settlement, the settlor cannot benefit from this and so sections 622 and 624 to 627 ITTOIA 2005 do not bite.

This result comes about because the whole property held on trust can be regarded as held on different sub-trusts for the purposes of the POAT provisions. Initially, this interpretation was not the view of some lawyers who took the view that the whole property (i.e. the policy) is comprised in one settlement, but with the settlor having a reversionary interest in that settled property.

However, following the amendment to Schedule 15 of the Finance Bill 2004, HMRC has given written confirmation of the favourable interpretation of this legislation in its letter to the ABI and this is very reassuring.

Discounted gift trusts

Under a discounted gift trust the settlor reserves the right to receive certain benefits on future specified dates during their lifetime. The trust is therefore split into “two pots”: one to pay the settlor their benefits; and the other (i.e. the remainder) is held for beneficiaries under the terms of the trust.

Variations of the trust do exist. However, a common thread is that, under the scheme, the settlor carves out their rights under the trust and gifts the other rights from which they cannot benefit. This means that there is no GWR. It is, however, also important to ensure that the scheme is not caught by the specific life policy anti-avoidance rule in FA 1986, Sch 20 para 7 and this can be achieved by using a capital redemption plan or making sure that the policy is not on the life of the settlor or their spouse/civil partner.

From a POAT standpoint, HMRC confirmed in writing to the ABI that the commonly understood forms of discounted gift trust should not, in general, be caught by the POAT rules on the basis that…

> (i) the benefits held for the settlor (in whatever form) are held on bare trust for them and are not therefore part of a settlement; and
>
> (ii) whilst the gifted property which is held subject to a power of appointment trust is held in a settlement, because the settlor is excluded from benefit, sections 622 and 624 to 627 ITTOIA 2005 do not apply and so the POAT provisions are not applicable.

As mentioned under the revert to settlor section above, some lawyers had initial difficulty in agreeing with HMRC’s interpretation of these provisions in relation to schemes where the whole of the trust property is in trust with the settlor being entitled to benefit on reversions at future dates. However, the amendment to

Schedule 15 of the Finance Bill 2004 makes it clear that the POAT rules should not apply. Further comfort exits because of HMRC's categoric statement to the ABI which was based on an understanding of all the facts and made in full knowledge of the use to which it will be put. Furthermore, HMRC have confirmed their approach on this in their guidance notes on POAT.

Retained interest trusts

A retained interest trust is a special type of trust that carves out a proportion of the initial trust capital for the absolute benefit of the settlor with the balance commonly held on flexible power of appointment trusts for the benefit of their family but from which the settlor is excluded from benefit.

Investment growth accrues across the value of both shares of the trust fund, but the settlor can draw down capital from their share of the trust fund and spend this cash as income.

The trust is not subject to the GWR rules because the settlor's interest is distinctly carved out from the property gifted and the settlor cannot benefit from the gifted share. Neither should the POAT rules apply because neither part of the trust fund, when separately tested, is caught by sections 622 and 624 to 627 ITTOIA 2005.

Loan trusts

The basis of gift and loan trusts and "loan-only" trusts (collectively referred to as "loan trusts") is that a settlor establishes a trust under which they are excluded from benefit. This will be done either by making a small gift or merely declaring a trust. The settlor then makes an interest-free loan repayable on demand to the trustees who invest in a single premium investment bond.

The IHT GWR rules should not apply to loan trusts on the basis that the settlor cannot benefit under the trust (and so FA 1986, Sch 20 para 5(4) cannot apply to treat property acquired with the loan as being property with a reservation of benefit). Furthermore, the settlor's entitlement to request the loan repayments is a contractual right and not a benefit in the context of the GWR provisions.

As far as the POAT rules are concerned, it was first thought that these rules could not apply because, although the arrangement involved a settlement, the settlor enjoyed no 'benefit' under the settlement. This meant that sections 622 and 624 to 627 ITTOIA 2005 could not apply and neither could the POAT rules. If anything, the settlor was a creditor of the trust and so an income tax charge could only arise under s633 ITTOIA 2005 – and that was only if income arose under the trust.

Initially, HMRC thought otherwise and quoted *Jenkins v CIR* 26 TC 265 as authority to justify its view that the settlor did enjoy a benefit in these circumstances. This was on the basis that because the trustees could use income of the trust fund directly or indirectly to repay the settlor's loan, this gave the settlor a benefit under the trust.

Fortunately, HMRC had second thoughts. In its letter dated 17 September 2004 to the ABI, as referred to above, HMRC confirmed its view in considering the application of the POAT rules that it is necessary to see if the trust and loan are caught in isolation from each other. Clearly the trust is not caught because the settlor is not a potential beneficiary. And neither is the loan because the loan is not a settlement for IHT purposes. On this basis, HMRC takes the view that the POAT rules do not apply. This is confirmed by their statement in their guidance notes on the POAT which states as follows:

"The settlor effects a policy and settles it on trust for the benefit of others. They then make a substantial interest-free loan to the trustees, repayable on demand. The trustees use the loan to purchase more policies, and make partial surrenders each year to pay off part of the loan.

This arrangement is not a gift with reservation for inheritance tax. The settlor is not a beneficiary of the trust itself and the making of the loan does not constitute a settlement for the purposes of inheritance tax. No charge to tax will arise under this schedule." (Schedule 15 Finance Act 2004 – the POAT provisions).

Split trusts

It will often be the case that an individual effecting a protection policy that pays out on the earlier of critical illness and death will want to ensure that the death benefits are paid free of IHT under trust and the critical illness benefits, if paid, will be paid to them. In these circumstances, a "split trust" can be used under which the critical illness benefits are held absolutely for the settlor and the death benefits are held on power of appointment trusts for the settlor's family.

This would not give rise to a GWR (under s102 Finance Act 1986) for IHT because, under the carve-out principle discussed above, the only property gifted is the death benefits which are held on flexible trusts under which the donor is excluded from benefit. Sch 20 para 7 of Finance Act 1986 is also relevant although the impact of this can be avoided.

The value of the critical illness benefits remains in their taxable estate with the death benefits being outside their estate. Of course, the value of those benefits is small whilst the life assured is in good health.

The POAT rules should not apply to this type of trust on the basis that…

a. the critical illness benefits are held on absolute trust for the settlor and so are not part of settled property;

b. the settlor is not a potential beneficiary of the balance of the policy benefits which are held under a settlement.

Probate trusts

Probate trusts are often used in connection with offshore life assurance policies as a means of avoiding the need to obtain probate on the trust assets on the settlor's

death. This may otherwise be necessary in both the country of the settlor's domicile and the jurisdiction in which the life office is based.

The purpose of the probate trust is simply to avoid the need for probate. Clearly the probate trust offers no IHT advantages because the trust property remains fully in the taxable estate of the settlor – either because they have a pre-22 March 2006 interest in possession or because of the GWR rules.

Sch 15 para 11 states that the POAT rules will not apply in respect of property that remains in the taxable estate of the donor which is the case here. Therefore, because this trust offers no IHT advantage, there is no POAT charge.

Business trusts

HMRC originally made the following statement with regard to business trusts in its guidance notes…

"A partner in a business effects a life assurance policy subject to a business trust. The partner is a potential beneficiary.

Provided the arrangement is commercial it is not a gift with reservation for inheritance tax. However, the trust is a settlement for inheritance tax purposes and a charge to tax will arise under paragraph 8 of this schedule."

This was then superseded by the following guidance released on the HMRC website on 4 April 2005…

"In some cases, policies are taken out on each partner's life solely for the purposes of providing funds to enable their fellow partners to purchase his/her share from the partner's beneficiaries on their death. The partner is not a potential beneficiary of his/her "own" policy. In such circumstances, a charge to tax under paragraph 8 of this schedule will not arise.

However, in many cases, the partner retains a benefit for themselves, for example they can cash in the policy during their lifetime for their own benefit. In such cases, even if the arrangement is on commercial terms so that it is not a gift with reservation for inheritance tax, the trust is a settlement for inheritance tax purposes and a charge to tax under paragraph 8 will arise."

Life policies will typically be effected subject to these trusts to enable cash to be placed in the hands of co-business owners on the death of a business owner. While the HMRC talks in terms of 'partners', these arrangements are also frequently set up by shareholders in a private limited company.

Under the terms of the trust, only business owners can benefit. Spouses/civil partners and family members, who are not also business owners, are excluded. However, in order to provide flexibility should the settlor leave the business, the settlor will be a beneficiary, either as a member of a discretionary class to whom appointments can be made or as a beneficiary who will benefit on leaving the business when benefits revert to them automatically under the trust.

HMRC has previously taken the view that provided the arrangement is a commercial transaction, i.e. only business owners can benefit and each business owner pays an amount commensurate with their expected benefit under the arrangement, so that the arrangement is demonstrably on arm's length terms, there will be no donative intent and no transfer of value and so, in reliance on the exemption in IHTA 1984, s10 (exemption for dispositions not intended to confer a gratuitous benefit), no GWR issues arise.

However, HMRC takes the view that, despite commerciality, the trust is a settlement and as the settlor can benefit, and the GWR rules do not apply, the POAT rules could apply.

Whether the latter can apply or not probably depends on the type of trust being used. In this respect, traditionally there have been two types of trust. Under one, the settlor is normally one of the potential beneficiaries to whom the trustees can make an appointment of benefits, perhaps if they leave the business, so that they can then take control of their policy which is no longer needed for business protection purposes. Here, it is probably true that legally the POAT rules could apply.

They may apply to a very low, or no value asset in the shape of the life policy. This will all depend on the facts but, with a term policy and a life assured in good health, the ascertained benefit is likely to be significantly below the *de minimis* value for the charge to apply.

In the other type of typical trust, the benefits will be held for the other business owners on the death of the life assured in the appropriate shares. However, here a proviso will normally state that should the settlor leave the business or dispose of their interest in the business, then the benefits will revert absolutely to the settlor. This would be more akin to a contingent reversionary interest under the trust.

On the basis that this interest is held absolutely for the settlor, it could be an interest under a bare trust which is not a settlement for the purposes of the provisions in FA 2004, Sch 15. However, a counter argument would be that as the settlor can influence when they retire or leave the business, a clean carve out has not taken place and so the 'bare trust for settlor' defence would not be successful.

Given HMRC's statement that the POAT provisions will apply if the settlor can benefit, there would seem to be a high tax risk attached to business trusts under which the settlor could benefit, although in practice there would be no tax due if the policy has no value.

Pre 18 March 1986 policies

The GWR provisions came into effect on 18 March 1986. From that date, if the settlor includes themselves as a potential beneficiary under a trust, this will be a GWR. However, policies effected before that date could be subject to such trusts.

An exemption exists from the GWR provisions on premiums paid post 17 March 1986 that were within the original amount payable under the contract or increased

at a pre-arranged rate, say under a cost of living increase option (FA 1986, s102(6)).

HMRC originally took the view that regardless of the IHT exemption, any premiums paid on or after 18 March 1986 were nonetheless additions to the settled property and, if the settlor was a potential beneficiary under trust, would be within the POAT charge under FA 2004 Sch15 Para 8.

However, HMRC eventually accepted the argument that continuing to pay premiums under a pre-18 March 1986 life policy in trust did not result in property being added to the settlement. The premiums merely maintained the policy and the policy was the settled property. They included the following in their (now archived) POAT guidance…

Pre-18 March 1986 policies settled on trusts.

A charge under Schedule 15 does not arise where, before 18th March 1986, a life policy has been contracted and settled on trusts from which the settlor can benefit, even where premiums are paid after this date.

However, somewhat confusingly, the current guidance (which in 2012 was incorporated into the IHT Manual) states:

"Where a life policy was settled on trusts before 18 March 1986 and premiums continue to be paid after that date, there is a specific exemption from the reservation of benefit provisions where the premiums continue to be paid at the previous level or at a pre-determined increase in rate. Nevertheless, any premiums paid on or after 18 March 1986 are additions to the settled property and, if the settlor is a potential beneficiary under trust, will be within the POAT charge under FA 2004 Sch15 Para 8. The proportion of the settled property - the policy valued on an open market basis - in charge will be by reference to the premiums paid before 17 March and on or after 18 March 1986. This proportion is likely to increase year on year as more premiums are paid - although the chargeable amount will be subject to the de minimis exemption."

Therefore, in cases of this type, advisers could explore the following options with a view to mitigating any possibility of a POAT charge…

a. First, consider whether the notional income on the value of a trust policy will exceed the *de minimis* figure of £5,000 per annum. In this connection, where both parties to a marriage or a civil partnership are joint settlors of the trust and jointly fund premiums, the POAT benefit for each individual settlor will be calculated on a pro rata basis by reference to their individual premium inputs as a proportion of the current taxable value of the policy. In such a situation, a married couple or civil partners will therefore have a joint *de minimis* limit of £10,000. Accordingly, the taxable value of such a policy (assuming there are no other assets of either spouse/civil partner within the POAT regime and a premium input on a 50 / 50 basis) would need to exceed £444,444 to give rise to a POAT charge (i.e. £444,444 at 2.25%) for 2024/25.

b. Second, if a POAT charge does arise and the settlor does not need access to the trust fund, they should consider asking the trustees to exclude them as a beneficiary of the trust and thus take them out of the POAT regime. If there is a cluster of policies in trust, the settlor could be excluded from benefit from enough policies to bring the notional benefit on the remaining policies to below the £5,000 *de minimis* figure.

c. Third, in cases where a settlor has a short life expectancy, whether because of age or infirmity, then of course they may wish to pay the tax charge in order to enjoy the IHT freedom of the policy in trust.

d. Finally, if the settlor may need access to the trust fund during their lifetime and does not wish to pay the POAT income tax charge, they will need to make an election to HRMC before 31 January in the tax year following the one in which they created the trust on form IHT500 to the effect that the trust fund falls within the GWR provisions. Though it should be noted that Finance Act 2007 gives HMRC the discretion to extend the deadline.

Existing spousal interest trusts holding investment bonds

Where a pre-20 June 2003 spousal interest (Eversden) trust exists that holds an investment bond (an appointment having been made from the settlor's spouse to children), a POAT charge can apply based on 2.25% (as at 2024/25 tax year) of the value of the investment bond. There are various courses of action that can be taken to alleviate this problem, depending on the circumstances of the client. These will include...

- the settlor giving up their interest in all of the fund;
- the settlor giving up their interest in a part of the fund (so as not to exceed the de minimis limit);
- the trustees making an irrevocable appointment to the settlor and the settlor "starting again" with another lump sum scheme;
- the trustees appointing benefits to the named beneficiaries and they in due course executing another trust;
- electing that the arrangement is a GWR for IHT purposes.

In all of these cases, the potentially exempt transfer that is deemed to be made by the settlor's spouse will stay on the clock.

Summary

The life assurance industry can feel relieved that, in general, its products and trust packages have been relieved from charge under the POAT rules.

Some commentators, however, still feel somewhat concerned that HMRC's interpretation of the legislation does not accord with their own, meaning that

HMRC could at a later date do a U-turn and start to attack these schemes under the POAT legislation.

Four points are relevant in this respect...

(i) Having clearly stated in a 2004 Budget Press Release (REV BN40) and in a letter to the ABI that it is not their intention to attack these plans, this would indeed need a massive U-turn by the Government and HMRC. This seems most unlikely.

(ii) For over 30 years, tax planners have relied on HMRC concessions (not given by statute) on the application of the GWR rules. A good example of this is HMRC's letter in 1986 to Touche Ross (published in the Law Society Gazette on 10 December 1986 and in Taxation Magazine on 9 January 1987) confirming that the GWR rules would not apply to arrangements, such as an excluded property trust where the settlor is a potential beneficiary, and indeed later letters on the application of paragraph 7 Schedule 20 Finance Act 1986 to critical illness carve-out trusts.

Given that this position has existed for such a long time, it seems reasonable to rely on clear HMRC statements covering similar areas of tax law.

This is especially in light of the fact that HMRC would have realised the significance of its statement to the ABI and the use that would be made of it by the life assurance industry.

(iii) HMRC has not given an unrestricted exemption to all existing life assurance trust schemes whatever their nature; rather it has confirmed that the more popular types of schemes available in the market place will not be caught by POAT. Therefore, it could still take action against any provocative scheme introduced in the future - either on the basis of a discounted gift or otherwise.

(iv) Since 1 April 2018, any new scheme involving a trust of a life policy which is outside the IHT hallmark is notifiable under the Disclosure of Tax Avoidance Schemes (DOTAS) rules. This is regardless of any previously expressed HMRC views on a similar scheme.

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