

Life policy trusts - an outline

Reasons for using trusts and types of trust.

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Synopsis: Trusts have a strong role to play in connection with life assurance policies. For simple protection based policies providing benefits on death, the benefits of using a trust with a policy will be as follows...

- the proceeds of the policy on the death of the life/lives assured will be paid to the trustees (provided there is at least one surviving trustee) without having to wait for a grant of probate or letters of administration, thus avoiding any unnecessary delay;
- the policy proceeds are outside of the estate of the deceased and not subject to inheritance tax (IHT) (although discretionary trusts and post-21 March 2006 flexible power of appointment trusts may be subject to ongoing IHT charges in accordance with the relevant property regime);
- funds can be made available to pay any IHT liability on the estate of the deceased;
- by being a trustee or appointor, the settlor can retain an element of control over the ultimate destination of the policy proceeds where a discretionary or flexible trust is used.

Apart from straightforward situations such as those described above, trusts also play a very important role in the marketing of life assurance packages where trusts are used to provide a particular tax or financial planning advantage.

Practically any kind of trust can be used in connection with a life policy and these include...

- statutory trusts (Married Women's Property Act 1882 (MWWPA) trusts);
- absolute trusts;
- flexible power of appointment trusts;
- discretionary trusts;
- business trusts;
- pension trusts;
- reversionary trusts;
- critical illness carve-out trusts.

For tax purposes these trusts will all fall within the category of an absolute (or bare) trust, an interest in possession trust or a discretionary trust.

Almost all trusts effected on or after 22 March 2006 (other than bare trusts) will be subject to the discretionary trust (also known as the relevant property) regime for IHT, regardless of whether or not they are actually discretionary trusts.

Creating trusts of life policies

Generally speaking, under English law, a trust will be created by the transfer of an asset by a donor (known as the settlor) to trustees, or by the settlor declaring that they will hold a particular asset as trustee subject to a trust.

In the case of life assurance policies, the asset in question is the policy itself. Strictly speaking, in order to transfer a policy to a trust, the policy will have to be in existence. Although a transfer of an existing policy by way of assignment to the trustees is one method of creating a trust over a life policy, it is also possible for a trust of a policy to be created from the moment it is issued. This would normally be achieved by the proposer for the life policy requesting and directing the life office to issue the policy subject to the terms of a trust set out in a declaration of trust.

When a trust is created over an existing policy, this will normally be carried out by means of a trust deed which would also incorporate an assignment of the policy to the trustees, who would normally include the settlor (the original policyholder) and additional trustees.

When a policy trust is created from outset (i.e. at the proposal stage) then, although trustees can be appointed in the trust document, clearly it will not be possible to assign the policy to them at that time since the policy is not yet in existence. Under the concept of privity of contract which exists under English law, unless a contract is specifically made for the benefit of a third party (in accordance with the Contracts (Rights of Third Parties) Act 1999) a person can only have rights and obligations under a contract if they are a party to that contract or the assets subject to the contract have been validly transferred to them.

At the time of writing no life office in the UK allows for any of their contracts to be expressed for the benefit of a third party. Where the privity rule applies, clearly the trustees of a trust which is declared from outset are not a party to the insurance contract (which is made between the proposer and the insurance company) and the only legally valid method of transfer of title to an insurance policy is by way of assignment. Therefore even if trustees are appointed at outset in a trust request, in order to vest in them the title to deal with the policy, a subsequent deed of assignment will be necessary.

In practice, if a life office provides draft trust documentation which includes an appointment of additional trustees in a trust request, they are unlikely to insist on a separate deed of assignment.

The rules on vesting the title in additional trustees do not, however, apply to statutory trusts where trustees can be validly appointed in the trust request under the MWPA provisions and such trustees will have title to deal with the policy without the need for assignment.

Another method of creating a trust from outset and appointing additional trustees would be for the proposer to complete a trust request and the policy to be issued from outset subject to trust under which the proposer would be the sole trustee. The settlor would then have a subsequent power of appointment of additional

trustees by means of a separate deed incorporating assignment of the policy to all the trustees.

Special rules for creating valid trusts apply in Scotland.

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