IHT and estate protection - using term assurance and gift inter-vivos policies to protect lifetime gifts from IHT

Synopsis: How to use term assurance and gift inter-vivos protection policies effectively to protect lifetime gifts.

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When an individual makes a lifetime gift to another person, or to certain types of trust such as a bare/absolute trust, this will be a potentially exempt transfer (PET) for inheritance tax (IHT) purposes. Equally, where a lifetime gift is made to a trust which is subject to the relevant property regime, such as a discretionary trust, this will be a chargeable lifetime transfer (CLT)..

Unless the gifts qualify for an IHT exemption, such as the annual IHT exemption of £3,000, the gifts out of normal expenditure exemption, etc., these gifts will continue to form part of the person's estate for a period of seven years following the date of the gift.

Assuming the person making the gift survives for seven years, the gift will then no longer be included in the value of their estate and will be free of IHT on death – but what happens if death occurs within the seven years? Essentially, the gifts made will reduce the individual's nil rate band available on death, resulting in a larger IHT liability for the estate beneficiaries.

Example 1 – death occurring within seven years of a gift which is within the nil rate band

Rachel is divorced, with one adult son, Max, who will inherit all of her estate, including her house, on death. Her estate value is currently £1.7 million, comprised of her property worth £500,000, cash and premium bonds totalling £550,000 and ISA/Unit Trust investments valued at £650,000. She has not made any previous gifts (other than using her annual £3,000 exemption every year) so has her full nil rate band available.

The IHT on Rachel's estate would currently be calculated as follows:

£1.7 million estate value – (£325,000 nil rate band + £175,000 residence nil rate band) = £1.2 million taxable estate.

The IHT liability = £480,000 (40% x £1.2 million).

Rachel is very close to her niece, Naomi, who is keen to buy her first house and Rachel has decided she would like to help her get on the housing ladder, so gifts her a sum of £200,000 towards the property purchase – this will be a PET for IHT.

Assuming that Rachel survives the gift by seven years, and assuming all values and reliefs are unchanged on her death, Rachel's estate would be calculated as follows:

£1.5 million estate value – (£325,000 nil rate band + £175,000 residence nil rate band) = £1 million taxable estate.

The IHT liability = £400,000 (40% x £1 million).

Rachel also intends to gift monies to Max in future when he is ready to purchase his first home, but unfortunately, she dies just over five years after making the gift to Naomi. No IHT will be payable on the gift to Naomi as it falls within Rachel's available nil rate band. However, the amount of nil rate band which is available for the estate is reduced by £200,000, to £125,000.

The revised IHT calculation as a result of making the £200,000 gift to Naomi (and assuming that all values and reliefs are unchanged on her death) is as follows:

£1.5 million estate value – (£125,000 nil rate band + £175,000 residence nil rate band) = £1.2 million taxable estate. £200,000 failed PET - £200,000 nil rate band.

The IHT liability on the taxable estate will now be £480,000 (40% x £1.2 million).

Max loses out in this scenario, as the IHT liability on the residual estate of which he is the sole beneficiary, is £80,000 higher as a result of the gift to Naomi becoming a failed PET.

Naomi, meanwhile, has no IHT to pay as the gift she received was covered by Rachel's nil rate band.

<u>Life policy - term assurance</u>

Question...

How could Rachel have used term assurance to ensure that Max was not disadvantaged as a result of the PET to Naomi failing?

Answer...

- Rachel could have taken out a seven-year level term assurance plan, with a sum assured of £80,000, written into a discretionary trust with Max as a potential beneficiary.
- The sum assured is calculated as 40% (the IHT rate) of the £200,000 gift = £80,000.
- When Rachel died, the term assurance policy would have paid out £80,000 into the discretionary trust, which Max could then have used to pay the additional £80,000 IHT liability incurred as a result of the failed PET.
- However, Max would still need to meet the residual £400,000 IHT liability – if Rachel had also taken out a whole of life policy with a sum assured of £400,000 written into trust, the trust would have received sufficient funds to allow Max to meet the full IHT liability and would have inherited the full value of the residual estate.

- Rachel could have taken out a seven-year level term assurance plan, with a sum assured of £130,000, written into discretionary trust with Max as a potential beneficiary. This would allow him to pay the additional IHT payable as a result of the loss of the nil rate band caused by the failed PET.
- The sum assured is calculated as 40% (the IHT rate) of the nil rate band = £130,000.
- Rachel could also have taken out a seven-year gift inter-vivos policy, written into discretionary trust with Naomi as a potential beneficiary, allowing Naomi to use the proceeds to pay the IHT due on the gift.
- The gift inter-vivos policy should start with a sum assured that matches the maximum IHT liability on the gift i.e. £30,000 (40% x £75,000 - the amount of the gift in excess of the nil rate band). The sum assured would then reduce by 20% each year from the end of year three, to reflect the taper relief that comes into effect at that point. Essentially, the sum assured would reduce as follows...
    - Again, Max would still need to meet the residual £320,000 IHT liability on the estate – if Rachel had also taken out a whole of life policy with a sum assured of £320,000 written into trust, the trust would have received sufficient funds to allow Max to meet the full IHT liability and he would have inherited the full value of the residual estate.
    - To protect gifts made within the nil rate band, the sum assured will usually be calculated as 40% of the amount of the gift, up to a maximum of 40% of the nil rate band.
    - For the amount of a gift which exceeds the nil rate band, the sum assured will typically be 40% of the excess but will then reduce by 20% per annum from the end of year three to reflect the availability of taper relief.
    - All policies should be written into a suitable trust to avoid the policy proceeds forming part of the beneficiary's estate.

The example above focuses on a gift made within the nil rate band, but what about gifts which exceed the nil rate band?

Example 2 – death occurring within seven years of a gift which is in excess of the nil rate band

Now consider the implications of making a gift in excess of the nil rate band, using the same example of Rachel.

Rachel's niece, Naomi, has now decided she wants to buy a property in London, which is more expensive than the area in which she originally intended to live, and Rachel is willing to instead make a gift to her of £400,000.

Rachel still dies after five years, so the £400,000 PET fails.

The IHT calculation will now be as follows:

£1.3 million estate value – (£0 nil rate band + £175,000 residence nil rate band) = £1,125,000 taxable estate liable to IHT. £400,000 failed PET - £325,000 nil rate band = £75,000 liable to IHT, which is payable by Naomi.

No IHT is payable on the first £325,000 of the gift to Naomi, but there is no nil rate band available for the estate. Naomi will need to pay the IHT on the amount of the gift which exceeded the nil rate band i.e. £75,000 (£400,000 gift - £325,000).

<u>IHT taper relief</u>

If an individual dies within seven years of making a gift and there is IHT to pay on it, the amount of IHT payable depends on the length of time between the date of the gift and subsequent death.

Gifts made in the three years before death are taxed at 40%. However, gifts made three to seven years before death are taxed on a sliding scale known as “taper relief” – how this works is detailed in the following table:

Number of years between date of gift and death	IHT liability	Effective rate of IHT payable
0-3	100%	40%
3-4	80%	32%
4-5	60%	24%
5-6	40%	16%
6-7	20%	8%
7 years plus	0%	0%

Note: taper relief only applies if the total value of gifts made in the seven years before death is over the £325,000 nil rate band.

Back to our scenario, Naomi will need to pay IHT at the rate of 16% on £75,000 as Rachel died between five and six years after making the gift to her.

16% x £75,000 = £12,000 IHT payable by Naomi.

The estate will be liable to IHT on £1,125,000.

40% x £1,1250,000 = £450,000.

In addition to Naomi being liable to £12,000 IHT, Rachel’s son Max loses out again as the sole beneficiary of the estate – there is no nil rate band available, so the IHT liability is £130,000 higher (40% x £325,000) than it would have been if the PET to Naomi had not failed.

If Rachel had died after seven years, assuming that all values and reliefs are unchanged on her death, the IHT calculation would be £1.3 million estate value – (£325,000 nil rate band + £175,000 residence nil rate band) =

£800,000 taxable estate liable to IHT. The estate will be liable to IHT of 40% x £800,000 = £320,000.

Life policies - gift inter-vivos & term assurance

Question...

How could Rachel have used a combination of term assurance and a gift inter-vivos policy to ensure that Max and Naomi were not disadvantaged as a result of the PET to Naomi failing?

Answer...

Number of years between date of gift and death	IHT liability	Sum assured
0-3	100%	£30,000
3-4	80%	£24,000
4-5	60%	£18,000
5-6	40%	£12,000
6-7	20%	£6,000
7 years plus	0%	£0

Summary

Additional points to note

- The same protection principles apply to chargeable lifetime transfers (CLTs).
- If the protection policy is not taken out at the time the gift is made, e.g. a couple of years later, the term of the plan will need to be adjusted accordingly.
- Some protection providers do not offer gift inter-vivos policies specifically, but they may provide equivalent cover by proving a series of individual term assurance policies – using the example of the IHT payable on Naomi's gift above this would work as follows...

Term assurance policies	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Policy 1	£6,000	£6,000	£6,000	£6,000	£6,000	£6,000	£6,000
Policy 2	£6,000	£6,000	£6,000	£6,000	£6,000	£6,000	-
Policy 3	£6,000	£6,000	£6,000	£6,000	£6,000	-	-
Policy 4	£6,000	£6,000	£6,000	£6,000	-	-	-
Policy 5	£6,000	£6,000	£6,000	-	-	-	-
Total sum assured	£30,000	£30,000	£30,000	£24,000	£18,000	£12,000	£6,000

Comment

As demonstrated in the scenarios within this guide, an effective combination of whole of life, term assurance and gift-inter vivos policies can be used to protect the beneficiaries of a deceased individual's estate, and also to protect individuals who have received lifetime gifts from paying IHT if the PET later fails.

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