A bare trust with a protection policy

Synopsis: Using a bare trust with life assurance.

Date posted: 14.8.26

Why use a bare trust

A trust is an effective way to legally transfer property to another person (trustee(s)) to hold for the benefit of others (beneficiary (ies)). The current owner of the property divests beneficial entitlement to the property and so it is no longer in his/her estate for inheritance tax, divorce or insolvency purposes.

In the context of a new protection life policy (whole of life assurance or term assurance), frequently, the person taking out the policy will request that the insurance company issue the policy in the name of the trustees in trust for his/her beneficiaries. The policy will then be issued to the named trustees to hold for the benefit of those beneficiaries. This is known as a trust request.

Example: Grant is effecting a new term assurance policy for a death benefit of £500,000. He wants the policy to be placed in a bare trust for the benefit of his beneficiaries who are his children. By completing a trust request, the life policy will be issued to the trustees from outset.

It is however possible for a person who owns an existing policy to place that policy in trust by signing a declaration of trust over the policy. The policy is then effectively assigned to the trustees to hold for those beneficiaries.

What is a bare trust and why use it?

A bare trust (sometimes called an absolute trust) is a trust where the beneficiary(ies) are named at outset and cannot be changed.

Whilst a bare trust incorporates a degree of inflexibility, it can have offer advantages. For example...

- The settlor will know for certain who the beneficiaries will be.
- A bare trust is easy to administer.
- A bare trust is less complicated than a discretionary trust. It can also have certain tax advantages over a discretionary trust (see below).
- Where the settlor has already made chargeable lifetime transfers that use his IHT nil rate band of £325,000 and premiums paid to a policy subject to a discretionary trust would not be covered by IHT exemptions, premiums paid to a policy subject to a bare trust will give the settlor the chance to make PETs – see below.

Are there any drawbacks to using a bare trust?

Some of the possible drawbacks are as follows...

- The beneficiary cannot be changed and so if personal relationships between settlor and beneficiary deteriorate or break down, the trust cannot be changed.
- If a beneficiary dies, his/her interest will pass into his/her estate and be distributed according to his/her Will or an intestacy (although if there is more than one beneficiary and they hold as joint tenants, the deceased's interest will pass to the surviving beneficiary(ies)).
- If a beneficiary(ies), divorces or become insolvent, the value of his/her interest (which will normally be negligible unless the life assured is in ill health) - may be taken into account for the purposes of the divorce settlement or settling debts to his/her creditors.

When should a bare trust not be used?

A bare trust should not be used where...

- Flexibility is required for the trustees to change beneficiaries.
- More protection is required to change the terms of the trust in the event that a beneficiary dies, divorces or becomes bankrupt.
- More confidentiality is required over the existence of the trust and the beneficiaries thereunder.

The tax implications of placing a policy in a bare trust

The tax implications will depend on whether it is a whole of life policy or a term assurance that is to be placed in the bare trust.

It is necessary to consider the tax implications on three occasions...

- When the policy is placed in trust.
- When premiums are paid to the policy.
- When the death benefits are distributed to the beneficiaries of the trust.

Tax treatment of term policies in a bare trust

Placing the policy in trust

- When a new term policy is effected in a bare trust from outset, the payment of the first premium will be treated as a potentially exempt transfer (PET) unless the transfer is covered by other exemptions (i.e. the £3,000 annual exemption).
- Where the settlor makes a declaration of trust over an existing policy or assigns an existing policy into a bare trust, there will be a PET unless the transfer is covered by exemptions.

The value of the PET is the open market value of the policy. Provided the life assured is in good health, the open market value is likely to be nil.

Payment of premiums

- Premiums are exempt from IHT if they fall within the normal expenditure out of income exemption. This should be available if the premiums are payable on a regular basis, paid out of post-tax income and do not affect the settlor's (normally the life assured's) standard of living. Premiums can also be exempt if they fall within the settlor's available annual (£3,000) IHT exemption(s).
- Premiums which are not covered by available exemptions will be PETs to the extent the value of the policy increases. Such an increase is extremely unlikely with a term assurance policy. Premium payments are therefore likely to be chargeable lifetime transfers (CLTs).
- If full PET treatment is required on premium payments, cash could be gifted by the settlor to the trustees so they can make premium payments. This will involve the trustees opening a bank account.
- If the CLTs that are paid over a period of 7 years cause the settlor to exceed his available nil rate band, a lifetime IHT charge can apply which will be at 25% on the excess if the IHT is paid by the settlor.
- The available nil rate band that can be set against the settlor's taxable estate on death will be reduced by the value of the cumulative total of non-exempt premiums (CLTs and failed PETs) paid within the 7 years prior to the settlor's death.

Distributions from the trust

- There is no IHT payable on capital distributions to the named beneficiary(ies).
- The value of the beneficiary's share of the trust is deemed to be part of their estate for IHT purposes but this share will normally have no value until the life assured dies (or falls into serious ill health).

Tax treatment of whole of life policies in a bare trust

Placing the policy in trust

- When a new policy is effected in a bare trust from outset, the payment of the first premium will be treated as a potentially exempt transfer (PET) unless the transfer is covered by other exemptions (i.e. the £3000 annual exemption).

- Where the settlor makes a declaration of trust over an existing policy or assigns an existing policy into a bare trust, there will be a PET unless the transfer is covered by exemptions.
- The value of the PET is the open market value of the policy or the premiums paid if greater. The open market value will normally be the surrender value of the policy unless the life assured is in serious ill health when it may have a greater value.

Payment of premiums

- Premiums are exempt from IHT if they fall within the normal expenditure out of income exemption. This should be available if the premiums are payable on a regular basis, paid out of post-tax income and do not affect the settlor's (normally the life assured's) standard of living. Premiums can also be exempt if they fall within the settlor(s)'s available annual (£3,000) IHT exemption(s).
- Premiums which are not covered by available exemptions will be PETs to the extent the value of the policy (surrender value) increases. Any excess amounts will be chargeable lifetime transfers (CLTs).
- If full PET treatment is required on premium payments, cash could be gifted by the settlor to the trustees so they can make premium payments. This will necessitate the trustees opening a bank account.
- If the CLTs that are paid over a period of 7 years cause the settlor to exceed his available nil rate band, a lifetime IHT charge can apply which will be at 25% on the excess if the IHT is paid by the settlor.
- The available nil rate band that can be set against the settlor's taxable estate on death will be reduced by the value of the cumulative total of non-exempt premiums (CLTs and failed PETs) paid within the 7 years prior to the settlor's death.

Distributions from the trust

- There is no IHT payable on capital distributions to the named beneficiary(ies).
- The value of the beneficiary's share of the trust is deemed to be part of their estate for IHT purposes. Although the value of this share can be based on the surrender value of the policy, it will normally have little substantial value until the life assured dies (or falls into serious ill health).

Other important questions

Who should be trustees?

The person(s) setting up the trust would normally be automatically appointed as a trustee of the trust. This person(s) will also normally be the life assured under the trust so it makes sense to appoint an additional trustee to deal with the distribution of the policy proceeds after the life assured's death. This person could be the settlor's spouse or close trusted relative. In some cases the settlor may wish to appoint a professional adviser.

To reiterate, it is important that there will be a trustee alive after the settlor's death to administer the trust.

Are there any special considerations if the settlor and his/her spouse are taking out a policy on their joint lives?

Joint lives policies can be set up to pay out death benefits on either the first death or the death of the survivor.

Joint lives first death policy

Where the policy pays out on the first death and the intention is that the survivor will benefit, a trust might not be necessary. However, in some cases there may be a desire that the survivor will only benefit if he/she survives the first death by 30 days (to stop the proceeds falling in the survivor's estate if he/she subsequently dies a short time after the first death). In such cases, a "contingent trust" would be appropriate. This trust would set out that the survivor will only benefit if he/she survived the first death by 30 days.

Joint lives last survivor policy

Frequently spouses will take out policies on their joint lives with the intention that tax efficient cash becomes payable on the death of the surviving spouse. This is the time when inheritance tax is most likely to arise for a husband and wife and so it makes sense for a joint lives last survivor policy to be set up that will provide this cash on the second death.

In this case, both spouses would normally be a trustee, so it is important to appoint an additional trustee who can administer the trust after the second death. Having appointed benefits to the beneficiary in question (if a discretionary trust), that surviving trustee can then pay the cash to that beneficiary.

As that beneficiary will frequently also be an executor under the survivor's estate, that cash can then be used by that beneficiary to assist in meeting any inheritance tax then arising.

Where a policy is on joint lives and has two settlors, this will be treated as two separate trusts for inheritance tax purposes, one created by each settlor (for example, one by husband and one by wife).

How does the trust deal with any critical/serious illness benefit paid under the policy?

In some cases, a policy may be chosen that pays critical/serious illness benefits to the settlor with the settlor's beneficiaries being entitled to any death benefits. To achieve this objective, the trust can be a “split trust” which holds those critical/serious illness benefits for the benefit of the settlor but without impacting on the tax efficiency of the trust.

If the policy also includes benefits paid on the settlor’s terminal illness, the settlor will need to choose whether to keep these benefits for his/her own use or give them away.

It is appropriate to remember that if the settlor chooses to receive terminal illness benefits and is unable to spend them all by the time he/she dies, the remainder will form part of his/her taxable estate for inheritance tax purposes.

Do the trustees need to set up a bank account?

In general, the trustees will need to set up a bank account in one of two circumstances...

(a) Payment of premiums

Normally, the settlor(s) will pay premiums direct to the life office. However, in some cases the settlor(s) may wish to make cash payments to the trustees so that the trustees can make premium payments (see above). This will enable them to obtain potentially exempt transfer (PET) treatment on all premiums paid. The trustees will need a bank account to receive and make such payments.

(b) Payment of death benefits

The trustees will be entitled to death benefits and for the life office to make payment to them, the trustees will need a bank account.

In some cases (for example, a bare trust where the beneficiaries are named adults of sound mind) the life office, if instructed to by the trustees, may be prepared to make payment of the death benefits direct to those beneficiaries.

Does the trust need to be registered under the Trust Registration Scheme?

A bare trust holding a protection policy (whether term or whole of life) which only pays out on the death, terminal illness, critical illness, or disablement of the life assured, is generally excluded from having to register on HM Revenue & Customs’ (HMRC) Trust Registration Service (TRS) if they satisfy the following conditions...

- death benefits are distributed to the beneficiaries within two years of the date of the death, and
- if terminal illness or critical illness benefits are included, these are paid directly to the beneficiary entitled.

Where a trust holds a protection policy which has a surrender value, such as a whole of life policy, the trust will also be excluded from the registration providing...

- There have been no partial surrenders from the policy, and...
- In the event of a full surrender, benefits are paid immediately and directly to a beneficiary.

A trust must always be registered should it become liable to tax – for example because death benefits are invested having been held inside the trust for two years.

Should a trust need to be registered, it is the trustees' responsibility to do so. It should be noted that, in order to pay benefits to the trustees, the insurance company may require proof of registration and the trustees can obtain this by downloading a PDF output from the TRS.

Should professional advice be taken before setting up a life policy in trust?

Yes, the above notes are intended only as very general guidance. Individuals are recommended to consult their own professional advisers on what trust is appropriate to them based on their own particular circumstances.

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