A discretionary trust with a protection policy

Synopsis: Using a discretionary trust with life assurance.

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Why use a discretionary 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 discretionary trust for the benefit of his beneficiaries who are his children/grandchildren. By completing a **trust request**, the life policy will be issued to the trustees from outset.

However, it is 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 discretionary trust?

A discretionary trust is one where the trustees retain control over who will be the beneficiary(ies). A range of described beneficiaries (children, grandchildren, and spouses thereof) are named as a class of beneficiary at outset and the trustees can choose who benefits from these classes at a particular point in time. It is therefore a very flexible option.

Advantages of a discretionary trust

The advantages of writing a life policy subject to a discretionary trust are that...

- The beneficiary(ies) can be changed and so if the personal relationships between settlor and beneficiary deteriorate or completely break down, the beneficiary under the trust can be changed to reflect the new circumstances.
- If a beneficiary dies, his/her interest will not pass into his estate and so will have no impact on how his/her estate is distributed irrespective of whether this happens under his/her Will or by way of an intestacy.
- If a beneficiary(ies) divorces or become insolvent, the value of his interest will not normally be taken into account for the purposes of the divorce

settlement or settling debts to his creditors (and moreover, the value of a protection policy will not normally be significant).

- It gives flexibility to change the terms of the trust in the event that beneficiaries die, divorce or become bankrupt.
- It provides confidentiality over the existence of the trust and the beneficiaries thereunder.

Are there any drawbacks to using a discretionary trust

A discretionary trust will not be appropriate...

- Where the settlor requires certainty as to who will benefit on the life assured's death.
- In cases where the settlor has already made lifetime chargeable transfers that fully use his/her nil rate band, premiums paid to the policy will not be covered by inheritance tax exemptions and so would cause an IHT liability on the premiums paid

How do the trustees pay benefits to a beneficiary?

Having decided which beneficiary they wish to benefit, the trustees then make an appointment in favour of that beneficiary. This can be an irrevocable appointment (one they cannot change in the future) or a revocable appointment (one they can change in the future). They use a deed of appointment to do this.

Where the trustees wish to retain flexibility as to who should benefit in the future (because there could be changing circumstances in the future – for example due to deaths, divorces or changing relationships), it is best to make a revocable appointment.

What happens if the trustees do not make an appointment?

In order for the trust to be legally valid, there must be somebody who will benefit under the trust if no appointment is made. These are known as the default beneficiaries and will be the people that the settlor would currently wish to benefit.

So, for example, if the policy was being set up to provide funds to meet inheritance tax on the settlor's death, the names of the settlor's children could be included here. The naming of the default beneficiary gives the trustees an indication of who the settlor would wish them to benefit under the trust. The settlor can also sign an expression of wishes to give the trustees guidance on this.

The default beneficiaries (or their descendants) will become entitled if no appointment has been made at the end of the appointment period of 125 years – a most unlikely occurrence.

Can the settlor's spouse be a potential beneficiary?

If there are joint settlors, the answer is no. Otherwise there would be a gift with reservation of benefit which would neutralise any inheritance tax saving.

Where there is only one settlor, it would in theory be possible to include the settlor's spouse as a class of potential beneficiary. However, because the policy has no significant value until the settlor's (life assured's) death, it may be more appropriate to include the widow(er) of the settlor as a potential beneficiary.

In these circumstances, it would be important that widow(er) did not pay any premiums into the policy as otherwise a gift with reservation could arise. By including the widow(er) as a beneficiary, should the settlor die and cash benefits be paid, the trustees could appoint these benefits to the widow(er) should he/she have a need for cash at that time. It is thought that it would be unusual for this to be the case and so, in most cases, the widow(er) would not be included as a beneficiary.

Tax implications of placing a policy in a discretionary trust

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

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

Tax treatment of term policies in a discretionary trust

Placing the policy in trust

- When a **new** term policy is effected in a discretionary trust from outset, the payment of the first premium will be treated as a chargeable lifetime transfer (CLT) 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 discretionary trust, there will be a CLT unless the transfer is covered by exemptions.

The value of the CLT 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 paid 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 CLTs.

- IHT will be payable by the settlor at 25% on the value of any CLTs arising from premiums that cause the settlor to exceed his/her nil rare band. On the death of the settlor within 7 years, the IHT position on these CLTs will be re-tested to see if further IHT is payable. At this point, the CLTs will be subject to IHT at 40% but taper relief (at 20% per annum) will be available to reduce the IHT if the settlor survived at least 3 years from the date the premium was paid. If the re-calculated IHT bill after taper relief is less than the IHT already paid, the overpaid IHT cannot be recovered. 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) paid within the 7 years prior to the settlor's death.

Taxation of the trust and distributions from the trust

- IHT can apply to trust property at 10-year anniversaries (periodic charges) and when property is distributed from the trust (exit charges).
- Periodic charges are based on the value of the trust at a 10-year anniversary. That value is charged to IHT at 6% (30% of 20%) on the excess of the trust value over the nil rate band available to the trust.
- The value of the trust will be the open market value of the policy - in the case of a term policy this will be zero unless the life assured is in very serious ill health. Where the life assured dies and the death benefits become payable just before a 10-year anniversary and those death benefits remain inside the trust, the market value will be the value of those death benefits.
- The trust's nil rate band will be £325,000 less the value of any CLTs made by the settlor in the seven years before the creation of the trust. Where there are joint settlors, for IHT purposes, the arrangement will be treated as two trusts each created by one of the settlors and each with a nil rate band of £325,000.
- When capital distributions are made out of the trust to a beneficiary, an exit charge can arise.
- For capital distributions made in the first ten years of the trust, there will only be an exit charge if there was an IHT charge when the trust was created. This is unlikely to be the case.
- For distributions made from the trust after a 10 year periodic anniversary, any IHT exit charge will be determined by applying the average rate of IHT paid at the previous 10-year anniversary. If this was nil, there will be no exit charge on distributions in the following ten years. When an IHT charge did arise at the previous 10-year anniversary, the IHT charge on an exit charge will be determined by using the average rate of IHT paid at the last 10-year anniversary and multiplying it by the number of quarters (3 month periods) that have elapsed since the last 10-year charge arose. So, for example, if the

distribution is made six months after the last 10-year periodic charge, then the fraction to use will be 2/40ths whereas if the distribution is made 9 and a half years after the last 10-year periodic charge, the fraction to apply will be 38/40.

The tax treatment of whole of life policies in discretionary trust

Placing the policy in trust

- When a **new** whole of life policy is effected in a discretionary trust from outset, the payment of the first premium will be treated as a chargeable lifetime transfer (CLT) 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 discretionary trust, there will be a CLT unless the transfer is covered by exemptions.
- The value of the CLT is the open market value of the policy or the premiums paid if greater. The open market value will normally be the surrender value 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 paid on a regular basis, 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 CLTs.
- IHT will be payable by the settlor at 25% on the value of any CLTs arising from premiums that cause the settlor to exceed his nil rare band. On the death of the settlor within 7 years, the IHT position on these CLTs will be re-tested to see if further IHT is payable. At this point, the CLTs will be subject to IHT at 40% but taper relief (at 20% per annum) will be available to reduce the IHT if the settlor survived at least 3 years from the date the premium was paid. If the re-calculated IHT bill after taper relief is less than the IHT already paid, the overpaid IHT cannot be recovered. 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) paid within the 7 years prior to the settlor’s death.

Taxation of the trust and distributions from the trust

- IHT can apply to trust property at 10-year anniversaries (periodic charges) and when property is distributed from the trust (exit charges).

- Periodic charges are based on the value of the trust at a 10-year anniversary. That value is charged to IHT at 6% (30% of 20%) on the excess of the trust value over the nil rate band available to the trust.

- The value of the trust will be the open market value of the policy or the premiums paid, if greater. The open market value will normally be the surrender value unless the life assured is in very serious ill health. Where the life assured dies and the death benefits become payable just before a 10-year anniversary and those death benefits remain inside the trust, the market value will be the value of those death benefits.

- The trust's nil rate band will be £325,000 less the value of any CLTs made by the settlor in the seven years before the creation of the trust. Where there are joint settlors, for IHT purposes, the arrangement will be treated as two trusts each created by one of the settlors and each with a nil rate band of £325,000.

- When capital distributions are made out of the trust to a beneficiary, an exit charge can arise.

- For capital distributions made in the first ten years of the trust, there will only be an exit charge if there was an IHT charge when the trust was created. This is unlikely to be the case.

- For distributions made from the trust after a 10-year periodic anniversary, any IHT exit charge will be determined by applying the average rate of IHT paid at the previous 10-year anniversary. If this was nil, there will be no exit charge on distributions in the following ten years.

When an IHT charge did arise at the previous 10-year anniversary, the IHT charge on an exit charge will be determined by using the average rate of IHT paid at the last 10-year anniversary and multiplying it by the number of quarters (3 month periods) that have elapsed since the last 10-year charge arose.

So, for example, if the distribution is made six months after the last 10-year periodic charge, then the fraction to use will be 2/40ths whereas if the distribution is made 9 and a half years after the last 10-year periodic charge, the fraction to apply will be 38/40.

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 trusts for inheritance tax purposes, one created by each settlor (for example, one by husband and one by wife). Each trust will have its own nil rate band.

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 might need to set up a bank account in order to receive 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, where the trustees have made an absolute irrevocable appointment to a beneficiary and that beneficiary is an adult and 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 discretionary 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 or
- 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. Persons 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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