TECHNICAL SALES BRIEFING

IHT "BITESIZE" SERIES - PART SIX
LIFE ASSURANCE POLICIES AND INHERITANCE TAX

KEY POINTS

This Technical Sales Briefing:

- is the sixth in a series covering many aspects of UK Inheritance Tax (IHT). The full content is available on our uTech site
- deals with how life assurance policies interact with IHT.

LIFE ASSURANCE POLICIES AND INHERITANCE TAX

POLICIES WHICH FORM PART OF THE DECEASED'S ESTATE

Policies which belonged beneficially to the deceased at the time of their death and pass to their executors or administrators as part of the estate, or policies (normally under trust) in which the deceased has reserved themself a benefit (unless effected prior to 18 March 1986 and not varied subsequently so as to increase the benefits) are taxable with the deceased's other assets, unless they are left to the surviving spouse domiciled in the UK. The value of a unit-linked contract will normally be the value of the units allocated as at the time of death or any higher amount provided by the terms of the particular contract.

POLICIES WHICH ARE THE SUBJECT OF A GIFT

Policies which are the subject of a gift after 26 March 1974 will be treated as transfers of value and may be subject to IHT depending on whether the gift is regarded as a PET or not. The value of most policies will be taken to be the greater of:

a) the total of the premiums paid under the policy, or any policy for which it was directly or indirectly substituted, or

b) the market value

With most temporary assurances the value would be the market value of the policy, normally nil.

Where the assurance is one under which the benefit secured is expressed in units (the values of which are published and subject to fluctuation) and the payment of each premium secures the allocation of a specified number of such units then, if the value of the units allocated to the assurance on the payment of the premiums is less than the aggregate of the values of those units at the time of allocation, the total of premiums paid in calculating a) (above) will be reduced by the difference.

On or after 11 April 1978 the value of a transfer on death or where the transfer does not result in the policy ceasing to be part of the transferor's estate will be the market value.

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TRUST POLICIES

Policies written in trust could give rise to IHT for the reasons set out below.

GIFTS OF PREMIUMS

Where a conventional life policy is made subject to a trust, the premiums will constitute gifts by the settlor(s). It is likely that these will be covered by the settlor's £3,000 p.a. exemptions or the "normal expenditure" exemption as detailed earlier in this series. If the premiums are not fully exempt, the excess amounts will constitute chargeable lifetime transfers (CLTs) (to discretionary and other "relevant property" trusts) or potentially exempt transfers (PETs) (to absolute trusts).

Where the excess amounts are CLTs and are large enough, they may need to be reported. This may occur where single premium life policies are used. A return to HMRC will now only be necessary if the total of CLTs by the settlor in a tax year exceeds the nil rate band (currently £325,000), or the cumulative total of CLTs (including the one in question) in the preceding seven years exceeds the NRB.

For regular premium policies held subject to power of appointment (interest in possession) trusts created prior to 22 March 2006, the settlor should now pay the premiums directly to the life office. HMRC have confirmed that if this course of action is taken the payments to the life office would be treated, from that date, as PETs.

THE PERIODIC CHARGE AND DISCRETIONARY TRUSTS

Discretionary trusts (and other "relevant property" trusts created on or after 22 March 2006) are assessed to IHT at 10-yearly intervals, starting on the tenth anniversary of the creation of the trust. The trust will have a liability of, currently, 6% on any amount that exceeds the available NRB. In the case of joint settlors, there will be two NRBs available but it should be borne in mind that any CLTs made by each settlor in the seven years before the creation of the trust must also be taken into account.

The periodic charge would be applied to the value of the settled property, such as the policy, at the time of the charge. The basis of valuation is the open market value and this would usually be the surrender value. However, if the life assured were in serious ill-health then the value of the policy for IHT purposes may well be more than the surrender value. For non-term assurance policies, it would be necessary to take into account the premiums paid in the valuation for the purpose of the periodic charge if this is greater than the market value.

HMRC have confirmed to the Association of British Insurers (ABI) that they do not expect individuals to have medicals every 10 years for the purposes of the legislation. Provided the individual is not seriously ill to the best of their knowledge and belief, no further action would be needed.

Another area which needs to be considered is where the policy proceeds become payable shortly before the 10-year anniversary and it is not possible for the trustees to appoint the capital to beneficiaries free of trust before the periodic charge arises.

EXIT CHARGES

Exit charges can arise when property leaves the settlement, for example, when capital is appointed out of the trust to beneficiaries. The main example would be payment of the policy proceeds to the beneficiaries. The exit charge would often be nil if a payment were made within the first 10 years provided the value of the policy immediately after the trust was created, together with the cumulative total of the settlor's CLTs in the seven years prior to the creation of the trust, plus any added property, is below the NRB at the time of the exit. It is understood that if premiums under a life assurance policy in trust are paid direct to the life company they will not be added property.

The amount of an exit charge after a ten-year anniversary will depend on the effective rate of the previous periodic charge, if any. If there is no periodic charge there will therefore be no exit charge in the following ten years. If there was, then the exit charge will be a fraction of the previous periodic charge based on the number of quarters that have elapsed since the last periodic charge. So, for example, 5 years (20 quarters) after a periodic charge the fraction would be 20/40ths.

GIFTS WITH RESERVATION

Where a life assurance policy is effected on or after 18 March 1986 and is made the subject of a trust, if the settlor is a potential beneficiary under the trust, the policy will be regarded as property subject to a reservation of benefit.

Life assurance policies effected prior to 18 March 1986 under which the settlor is a potential beneficiary under a power of appointment trust will not be subject to the gift with reservation provisions unless the policy is varied on or after 18 March 1986 (whether by exercise of an option or otherwise) so as to increase the benefits secured or to extend its term.

The rules applicable to variation of benefits for Life Assurance Premium Relief purposes will be relevant in this context. Should benefits be increased under the policy, the proportion of the proceeds secured by the premiums paid on or after 18 March 1986 would be deemed to form part of the settlor's estate for IHT purposes.

Where a life assurance policy is effected subject to a discretionary or a flexible power of appointment trust under which the settlor's spouse/registered civil partner is a potential beneficiary the policy will not be regarded as 'property subject to a reservation of benefit' provided there is no intention that the amounts appointed to the spouse/registered civil partner will be used or in fact are used for the benefit of the settlor.

HMRC has confirmed that in the following examples where the settlor has retained an interest which he/she owned at the outset, a gift with reservation has not been made:

- a whole life policy effected by the life assured in trust for 'A' should 'A' survive the life assured, but otherwise for the life assured
- an endowment assurance policy effected by the life assured in trust for 'A' if living at the death of the life assured before the maturity date but otherwise for the life assured
- a whole life policy effected by the life assured in trust for 'A' if the assured should die before a specified date but otherwise for the life assured should they survive to that date or should 'A' predecease them

Further, where the settlor of a trust would benefit under the trust by operation of law, (because of a resulting trust) the trust property would not be regarded as property which is subject to a gift with reservation.

LIFE OF ANOTHER POLICIES

No IHT liability on payment of premiums would arise if the grantee paid all the premiums, since there is no element of gift involved – it is their policy. However, on the death of the grantee prior to the life/lives assured, the policy would form part of the grantee's estate and a liability would arise based on the market value of the policy.

THE EXEMPTIONS FOR PREMIUM PAYMENTS UNDER LIFE POLICIES WRITTEN IN TRUST (APART FROM SPOUSE EXEMPTION)

The normal expenditure exemption

Premium payments which fall within the terms of this exemption would be exempt from IHT. 'Normal' means habitual when it is applied to the facts of each case but HMRC has stated that this exemption will apply to the first premium in a series of payments under a policy.

HMRC has also stated that allowance for fluctuations in a person's income will be made by looking at the normal pattern of expenditure over a period of years. Thus if a person, having paid premiums out of income for a number of years, falls on hard times for one year and has to resort to capital to pay that year's premiums it would still be exempt as normal expenditure out of income.

Neither the capital element of an annuity effected after 12 November 1974 nor 'income' taken from an investment bond by withdrawals would be treated as income for the purposes of this exemption.

The £3,000 p.a. exemption

Premiums up to £3,000 p.a. would be exempt from the lifetime charge provided this exemption was not being used elsewhere.

The £250 p.a. exemption

This exemption can be used for trust policies for absolute beneficiaries, whether adult or infant, provided that the aggregate value of the outright gifts to any **one beneficiary** in any one year does not exceed £250.

*Note: availability of these exemptions is based on net premium if paid after deduction of life assurance premium relief from 6 April 1979.

The cumulative use of exemptions

It is possible to use the £3,000 exemption in addition to payments out of income which qualify as 'normal expenditure', for example, where payments are made partly out of capital or where the normal expenditure exemption is restricted. However, the £250 p.a. exemption cannot be used if other gifts are made to the same person in the same fiscal year. This exemption can also not be used in conjunction with other reliefs.

It should be borne in mind that where premium payments constitute PETs, the above exemptions only become applicable when those payments become chargeable transfers, for example where the settlor dies within seven years of the payment. Only at that time will HMRC consider a claim to an exemption.

ANNUITY/LIFE ASSURANCE COMBINATIONS

Where on or after 27 March 1974 an annuity and a life assurance policy are effected on the same life, if the assurance is vested in a person other than the person who purchased the annuity then unless it is shown that the effecting of the contracts is not an 'associated operation' the purchaser of the annuity shall be treated as making a transfer of value of the lesser of:

› the purchase price of the annuity plus the premium for the policy, or

› the value of the greatest benefit capable of being conferred by the policy at any time.

HMRC has previously stated that the contracts would not be caught by the 'associated operations' legislation if the policy had been issued on the same premium rates and medical evidence as if the annuity had not been purchased.

However, with effect from 31 December 1987 HMRC have regarded a policy as being issued on full medical evidence if it can be shown that the life assurance company has, as a minimum, obtained a private medical attendant's report and has used it as the basis of its normal underwriting procedures in the same way as it would have done had the annuity not also been purchased. HMRC can ask for the medical evidence to be produced in any particular case.

PARTNERSHIP POLICIES

If the premiums paid by the partners are roughly equated there would be no liability on the premium payments. If the arrangement between the partners is not regarded as commercial the gift with reservation provisions may apply.

FURTHER UPDATES IN THIS SERIES AND OUR UTECH SITE

This was the final Technical Sales Briefing in this series; we hope you have found it useful.

Note the content in this briefing is taken from our comprehensive Inheritance Tax Manual which is available in the Technical Briefings section of our uTech site (www.utmostinternational.com/wealth-solutions/our-wealth-solutions/united-kingdom/utech/). uTech has several other technical briefings exploring the more niche and complex areas of UK IHT. These include several guides to the Residence Nil Rate Band and a detailed briefing exploring Domicile, Remittance Basis and Excluded Property.

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