McKie & Co

INHERITANCE TAX PLANNING - TRUSTS, INSURANCE AND ALTERNATIVES:

SIMPLE USES OF INSURANCE POLICIES IN INHERITANCE TAX PLANNING

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RELEVANT LEGISLATION

Inheritance Tax Legislation

1.1

STATUTORY REFERENCE	PROVISION
IHTA 1984 s.167	**Life policies etc** '(1) In determining in connection with a transfer of value the value of a policy of insurance on a person's life or of a contract for an annuity payable on a person's death, that value shall be taken to be not less than – (a) the total of the premiums or other consideration which, at any time before the transfer of value, has been paid under the policy or contract or any policy or contract for which it was directly or indirectly substituted, less (b) any sum which, at any time before the transfer of value, has been paid under, or in consideration for the surrender of any right conferred by, the policy or contract or a policy or contract for which it was directly or indirectly substituted. (2) Subsection (1) above shall not apply in the case of- (a) the transfer of value which a person makes on his death, or (b) any other transfer of value which does not result in the policy or contract ceasing to be part of the transferor's estate,'
IHTA 1984 s.263	Annuity purchased in conjunction with life policy
FA 1986 ss.102 – 104 and Schedule 20	Gifts with reservation of benefit
FA 1986 ss.102(6) and (7)	Reservation of benefit rules do not apply to most policies issued before 18th March 1986

STATUTORY REFERENCE	PROVISION
FA 1986 Schedule 20 para 5(3) & (4)	(3) Where property comprised in a gift does not become settled property by virtue of the gift, but is before the material date settled by the donee, sub-paragraphs (1) and (2) above shall apply in relation to property comprised in the settlement as if the settlement had been made by the gift; and for this purpose property which becomes settled property under any testamentary disposition of the donee or on his intestacy (or partial intestacy) shall be treated as settled by him. (4) Where property comprised in a gift becomes settled property either by virtue of the gift or as mentioned in sub-paragraph (3) above, any property which - (a) on the material date is comprised in the settlement, and (b) is derived, directly or indirectly, from a loan made by the donor to the trustees of the settlement, shall be treated for the purposes of sub-paragraph (1) above as derived from property originally comprised in the gift.
FA 1986 Schedule 20 Paragraph 7	Disposal in connection with policy of insurance where benefits to donee vary by reference to benefits of donor 7 - (1) Where arrangements are entered into under which – (a) there is a disposal by way of gift which consists of or includes, or is made in connection with, a policy of insurance on the life of the donor or his spouse or on their joint lives, and (b) the benefits which will or may accrue to the donee as a result of the gift vary by reference to benefits accruing to the donor or his spouse (or both of them) under that policy or under

STATUTORY REFERENCE	PROVISION
	another policy (whether issued before, at the same time as or after that referred to in paragraph (a) above), the property comprised in the gift shall be treated for the purposes of the principal section as not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor. (2) In sub-paragraph (1) above – (a) the reference in paragraph (a) to a policy on the joint lives of the donor and his spouse includes a reference to a policy on their joint lives and on the life of the survivor; and (b) the reference in paragraph (b) to benefits accruing to the donor or his spouse (or both of them) includes a reference to benefits which accrue by virtue of the exercise of rights conferred on either or both of them.

Capital Gains Tax Legislation

1.2

STATUTORY REFERENCE	PROVISION
TCGA 1992 s.204	Policies of insurance:- (1) A gain accruing on a disposal of, or of an interest in, the rights conferred by a non-life policy of insurance is not a chargeable gain (but see subsection (2)). (2) If a disposal is of, or of an interest in, the rights conferred by a non-life policy of insurance of the risk of – (a) any kind of damage to assets, or (b) the loss or depreciation of assets, the exemption under subsection (1) does

STATUTORY REFERENCE	PROVISION
	not apply so far as those rights relate to chargeable assets. (3) For this purpose “chargeable assets” means assets on the disposal of which a chargeable gain – (a) may accrue, or (b) might have accrued. (4) Nothing in subsections (1) and (2) prevents sums received under a non- life policy of insurance of the risk of – (a) any kind of damage to assets, or (b) the loss or depreciation of assets, from being sums derived from the assets for the purposes of this Act (and, in particular, for the purposes of section 22). (5) A gain accruing on a disposal of, or of an interest in, the rights conferred by a contract for an annuity is not a chargeable gain if the annuity is – (a) a non-deferred annuity, or (b) an annuity granted (or deemed to be granted) under the Government Annuities Act 1929. (6) If any investments or other assets are, in accordance with a policy issued in the course of life assurance business carried on by an insurance company, transferred to the policy holder – (a) the policy holder's acquisition of the assets, and (b) the disposal of the assets to the policy holder, are to be taken for the purposes of this Act to be for a consideration equal to the market value of the assets.

STATUTORY REFERENCE	PROVISION
	(7) In this section "interest", in relation to any rights, means an interest as a co-owner of the rights. (8) It does not matter – (a) whether the rights are owned jointly or in common, or (b) whether or not the interests of the co-owners are equal. (9) In this section a "non-deferred annuity" means an annuity – (a) which is not granted under a contract for a deferred annuity, and (b) which is granted in the ordinary course of a business of granting annuities on the life of any person, and it does not matter whether the annuity includes instalments of capital. (10) In this section a "non-life policy of insurance" means – (a) a contract made in the course of a capital redemption business, within the meaning of Chapter 1 of Part 12 of the Taxes Act, and (b) any … policy of insurance which is not a policy of insurance on the life of any person.
TCGA 1992 s.205	Disallowance of insurance premia as expenses
TCGA 1992 s.210	Life assurance and deferred annuities:- (1) This section has effect in relation to any policy of insurance or contract for a deferred annuity on the life of any person. (2) A gain accruing on a disposal of, or of

STATUTORY REFERENCE	PROVISION
	an interest in, the rights conferred by the policy of insurance or contract for a deferred annuity is not a chargeable gain unless subsection (3) below applies. (3) This subsection applies if - (a) (in the case of a disposal of the rights) the rights or any interest in the rights, or (b) (in the case of a disposal of an interest in the rights) the rights, the interest or any interest from which the interest directly or indirectly derives (in whole or in part), have or has at any time been acquired by any person for actual consideration (as opposed to consideration deemed to be given by any enactment relating to the taxation of chargeable gains). (4) For the purposes of subsection (3) above - (a) (in the case of a policy of insurance) amounts paid under the policy by way of premiums, and (b) (in the case of a contract for a deferred annuity) amounts paid under the contract, whether by way of premiums or as lump sum consideration, do not constitute actual consideration. (5) And for those purposes actual consideration for - (a) a disposal which is made by one spouse or civil partner to the other or is an approved post-marriage disposal or an approved post-civil partnership disposal, or (b) a disposal to which section 171(1)

STATUTORY REFERENCE	PROVISION
	applies, is to be treated as not constituting actual consideration. (6) For the purposes of subsection (5)(*a*) above a disposal is an approved post-marriage disposal or an approved post-civil partnership disposal if - (a) it is made in consequence of the dissolution or annulment of a marriage or civil partnership by one person who was a party to the marriage or civil partnership to the other, (b) it is made with the approval, agreement or authority of a court (or other person or body) having jurisdiction under the law of any country or territory or pursuant to an order of such a court (or other person or body), and (c) the rights disposed of were, or the interest disposed of was, held by the person by whom the disposal is made immediately before the marriage or civil partnership was dissolved or annulled. (7) Subsection (8) below applies for the purposes of tax on chargeable gains where - (a) (if that subsection did not apply) a loss would accrue on a disposal of, or of an interest in, the rights conferred by the policy of insurance or contract for a deferred annuity, but (b) if sections 37 and 39 were disregarded, there would accrue on the disposal a loss of a smaller amount, a gain or neither a loss nor a gain.

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	(8) If (disregarding those sections) a loss of a smaller amount would accrue, that smaller amount is to be taken to be the amount of the loss accruing on the disposal; and in any other case, neither a loss nor a gain is to be taken to accrue on the disposal. (9) But subsection (8) above does not affect the treatment for the purposes of tax on chargeable gains of the person who acquired rights, or an interest in rights, on the disposal. (10) The occasion of - (a) the receipt of the sum or sums assured by the policy of insurance, (b) the transfer of investments or other assets to the owner of the policy of insurance in accordance with the policy, or (c) the surrender of the policy of insurance, is for the purposes of tax on chargeable gains an occasion of a disposal of the rights (or of all of the interests in the rights) conferred by the policy of insurance. (11) The occasion of - (a) the receipt of the first instalment of the annuity under the contract for a deferred annuity, or (b) the surrender of the rights conferred by the contract for a deferred annuity, is for the purposes of tax on chargeable gains an occasion of a disposal of the rights (or of all of the interests in the rights) conferred by the contract for a

STATUTORY REFERENCE	PROVISION
	deferred annuity. (12) Where there is a disposal on the occasion of the receipt of the first instalment of the annuity under the contract for a deferred annuity - (a) in the case of a disposal of the rights conferred by the contract, the consideration for the disposal is the aggregate of the amount or value of the first instalment and the market value at the time of the disposal of the right to receive the further instalments of the annuity, and (b) in the case of a disposal of an interest in the rights, the consideration for the disposal is such proportion of that aggregate as is just and reasonable; and no gain accruing on any subsequent disposal of, or of any interest in, the rights is a chargeable gain (even if subsection (3) above applies). (13) In this section "interest", in relation to rights conferred by a policy of insurance or contract for a deferred annuity, means an interest as a co-owner of the rights

Income Tax Legislation

1.3

STATUTORY REFERENCE	PROVISION
ICTA 1988 ss.266 – 278 and Schedule 15	Life assurance premium relief - still important for determining whether a policy is a qualifying policy or not
ITTOIA 2005 Part 4 Chapter 9 (ss.461-546)	Gains from contracts for life insurance etcetera

STATUTORY REFERENCE	PROVISION
FA 2004 s.84 and Schedule 15	Charge to Income Tax on benefits received by former owner of property (Pre-Owned Assets Tax)

SEVEN YEAR TERM COVER

Introduction

2.1 If one makes a potentially exempt transfer within seven years of death, it will become chargeable by reason of the death.[1] If one makes an immediately chargeable transfer, it will be charged initially at the lifetime rate of tax (twenty per cent)[2] but if one dies within seven years of the transfer, the death rates will apply to it and, if the tax at death is greater than the tax at the lifetime rates, further tax will be payable. That tax will be charged at forty per cent subject to a series of deductions starting at twenty per cent in the fourth year and reducing the chargeable amount to nil after the seventh year.[3]

2.2 So when one makes a potentially exempt transfer one's estate (or the donee if the donee is to bear the tax), is at risk if one dies within seven years. Risk protection is what the insurance industry does best and it can supply two "off the peg" products to match this contingent liability.

Gift-Inter-Vivos Cover

2.3 The first is gift-inter-vivos cover. This is a decreasing term cover designed to match the decreasing rates of Inheritance Tax on potentially exempt transfers. So, if one takes cover of £100,000, the policy will pay out the following amounts:-

0 – 3 years	£100,000
3 – 4 years	£ 80,000
4 – 5 years	£ 60,000
5 – 6 years	£ 40,000
6 – 7 years	£ 20,000

Seven Year Level Term Assurance

2.4 This deals with the immediate liability on the transfer but does not deal with the increased tax which can be payable on the estate itself by reason of the fact that the previous transfer within seven years of death is added to the settlor's cumulative total. For example, if a settlor with no previous chargeable transfers, except that he has used his annual exemptions, and with an estate of £500,000 makes a transfer of £325,000

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1 Section 3A(4). All reference in this lecture are to the Inheritance Tax Act 1984 unless otherwise stated
2 Section 7(2)
3 Section 7(4)

there will be no tax chargeable on this lifetime transfer regardless of when he dies. If, however, he dies within seven years of the transfer, the tax chargeable on his estate will be £70,000. This is so whether he dies immediately after the transfer or seven years after the transfer. If, however, he dies seven years and one day after the transfer, his previous chargeable transfer will have dropped out of his cumulative clock of chargeable transfers. His estate will then be entirely covered by the Nil-Rate Band. So gift inter vivos cover is not appropriate in this situation. Instead one needs to take seven year level term assurance to cover this risk.

Mixing Gift Inter Vivos and Level Term Assurance

2.5 If the potentially exempt transfer is only partially covered by the nil rate band, death within seven years will result in tax being chargeable on the estate and on the lifetime gift. A mixture will then be needed of level term cover to cover the increased liability of the estate and gift inter vivos cover to cover the potential liability on the chargeable transfer itself.

Immediately Chargeable Transfers

2.6 If one makes an immediately chargeable transfer, assuming that tax rates and bands do not change between the time of the transfer and the date of death, one will pay additional tax if the tapered death rate is greater than the lifetime rate.[4] As one can see from the following table, that means that the tax will be increased if you die up to five years after the transfer.

	Death Rates	**Lifetime Rates**
0 – 3 years	40%	20%
3 – 4 years	32%	20%
4 – 5 years	24%	20%
5 – 6 years	16%	20%
6 – 7 years	8%	20%

2.7 I am not aware that any insurance company offers a product tailored to this pattern of liability perhaps because the reduction in liability from Years 3 - 5 is not significant enough for there to be a sufficiently large market to justify a bespoke product. This liability is probably best covered through a five year level term assurance accepting that if the death occurs after the end of the third year, the estate would be in surplus.

Writing in Trust

2.8 As term assurance of this type pays out only on the death of the policyholder there is no point in keeping the policy within his estate. To do so would be to subject the policy itself to Inheritance Tax. Therefore such a policy should always be written in trust. Of course, one needs to consider who the beneficiaries of such a trust should be. Normally they will be the persons who will ultimately bear the relevant Inheritance Tax liability.

4 Section 7(5)

With gift-inter-vivos cover that might be the residual beneficiary of the donor's estate or it might be the donees if the gift was made subject to Inheritance Tax.

COUPLING LONG TERM CARE INSURANCE AND AN INVESTMENT BOND

3.1 This product works by combing a long term care policy which pays out in the event of major disability or illness with a conventional investment bond written in trust for the investor's heirs and beneficiaries. Say, for example, there is a total investment of £100,000 but it is split between £40,000 going into a long term care bond and £60,000 going into an investment bond. The investor can draw benefits from the long term care bond but is excluded from benefitting from the investment bond. In order to avoid the application of Schedule 20 Paragraph 7, the benefits payable on the investment bond are entirely independent of those payable on the long term care bond.

3.2 The result is, using the figures given above, that on making the investment the investor will make a PET of £60,000. The long term care bond will be an asset in his estate at death because it is to be valued immediately before the investor's death. Because the policy is not likely to be worth very much at the time immediately before the investor's death, no significant amount of value will come into charge to Inheritance Tax.

3.3 At first sight this seems like a major Inheritance Tax saving. £40,000 falling out of account immediately combined with a £60,000 PET which will be outside the scope of Inheritance Tax if the investor survives seven years. But surely it is a good example of mere packaging. There is no necessary connection between making an investment in a long term care bond and in an investment bond written in trust. The reason the long term care bond is not subject to Inheritance Tax at death is because it is generally worthless at that time. All one has done is buy security for one's lifetime so it is not surprising if there is no Inheritance Tax to pay on one's death.

MIXED TRUST INTERESTS FOR SETTLOR AND BENEFICIARIES

4.1 Under this scheme the investor takes out a single premium bond which is written on trusts under which a specified proportion is held for the investor's heirs. The remaining proportion of the trust fund is held for the investor absolutely. The net result is that it is hoped that the investor has made a potentially exempt transfer equal to the value of the bond held in the beneficiaries' fund.

4.2 The bond is notionally divided into two portions corresponding to the percentage interests of the donor's fund and the beneficiaries' fund respectively. It is therefore possible for the trustees to take withdrawals which are charged entirely to one fund or the other. The investor may require withdrawals to be made from his fund. Although the withdrawals are wholly charged to the investor's portion of the policy, the five per cent tax free withdrawal provided by Section 546 ICTA is calculated by reference to the premium paid for the policy as a whole.

4.3 In effect, that is the only tax advantage provided by this strategy. Otherwise, all one is doing is writing an investment in trust for one's heirs equal to the beneficiaries' portion of the bond and retaining an investment represented by the donor's fund.

4.4 This is a fairly standard advantage which I understand is accepted by the Inland Revenue. On technical grounds, however, its efficacy appears doubtful. Surely the ability to take a tax free withdrawal calculated by reference to the property which one has given away is a benefit given by contract within s.102(1)(b). Even if it is not, one could surely argue that FA 1986 Schedule 20 Paragraph 7 applies because the beneficiaries' fund will be reduced by Income Tax arising on chargeable events occurring after the investor's death and that Income Tax charge will be calculated by reference to the benefits previously paid to the donor.

COMBINING AN INVESTMENT BOND WITH AN INCOME BOND

5.1 Under this product a lump sum investment is split between a single premium insurance bond written in trust for the beneficiaries and another single premium insurance bond designed to produce a "yearly" income for the investor. This bond is in effect an annuity fund so that if the investor takes the full "income" from the bond in each year, it will be valueless at his death. If he takes less than the full income, the surplus will be held within the bond and will build up a capital value which will be subject to Inheritance Tax on his death.

5.2 To all intents and purposes this is no more than the packaging of two products. One a simple insurance bond written in trust for the beneficiaries. The other, an annuity bond reserved by the investor. The Inheritance Tax saving comes from both products but independently from each other. From the investment bond, because it is written in trust and falls outside the settlor's estate and from the annuity bond because it gives rights to participate in earnings which cease on death.