Protection

Learning Outcome 5

By the end of this learning material you will be able to demonstrate an understanding of the taxation treatment of life assurance and pension based protection policies.

5.1 Qualifying, non-qualifying and offshore policies

NOTE: This section applies to UK policies, unless specifically stated otherwise.

Qualifying

- The gain on a qualifying policy is generally not taxable for the policyholder

Non-qualifying

- The gain on a non-qualifying policy could be subject to higher rates of income tax.

The gain on an offshore policy could be fully taxable.

Qualifying Rules

The qualifying rules are slightly different for different types of policies. Main types of policy are:

- Temporary assurance with a term of more than 10 years
- Temporary assurance with a term of 10 years or less
- Whole of Life plans
- Endowment policies
- Exempt policies.

Until recently there has been no limit on the premiums that can be paid to qualifying life insurance policies.

These policies provide a tax advantage for higher/additional rate tax payers in that any gain on termination of the policy is not subject to excess rates of income tax.

The gain is not subject to basic rate tax in any event since the investment funds already suffer tax at source. Changes were made on 6 April 2013 to restrict the advantage that can be gained through investment in these policies.

Since then premiums payable by an individual to qualifying policies are restricted to £3,600 per annum. This limit is on the aggregate of premiums payable to all Qualifying Policies made by an individual on or after 21 March 2012, and also to policies made before that date (known as ‘protected policies’) where the policy is varied or an option is exercised so as to increase the premium or extend the term on or after 6 April 2013.

Where a protected policy is altered in that way and the individual is in breach of the premium limit, the policy will be a restricted relief Qualifying Policy and only 'qualifying premiums' will count towards any gain that is not subject to excess rates of tax i.e. some of the gain will be taxable.

The policyholder will have the opportunity to cancel the alteration, within 3 months, so as to retain Qualifying Policy status. Policies effected and still maintained to repay a mortgage are exempt from these provisions.

If a policy is assigned on or after 6 April 2013 it will become either a non-qualifying policy or a restricted relief Qualifying policy depending on the nature of the assignment.

The rules apply to a policy beneficiary, defined as an individual who owns the rights or a share in the rights in a policy. Where the policy is in trust, the beneficiary of the policy is the trust beneficiary if it is a bare trust or otherwise it is the settlor.

Where on or after 6 April 2013 a new policy is issued or there is an alteration (as described above) or there is a policy assignment then each policy beneficiary must complete a declaration within 3 months of the event, confirming whether or not the beneficiary is in breach of the premium limit.

Failure to comply within the 3 month timescale will result in the policy becoming non-qualifying.

Temporary Assurance with a term of more than 10 years

- The policy must provide a capital sum on death or earlier disability and no other benefits
- "Other benefits" do not include surrender values, annuity options, increasable options, waiver of premiums on disability and disability benefits of a capital type
- Premiums must be paid at annual or shorter intervals for at least 10 years or three-quarters of the term whichever is the shorter
- The total premiums payable in any one year must not exceed twice the total premiums payable in any other year
- The total premiums payable in any year must not exceed one eighth of the total premiums payable over the whole term
- For policies effected on or after 1 April 1976, the capital sum on death must be not less than 75% of the premiums that would be payable if death were to occur on the life assured's 75th birthday. Where the sum assured can be paid as a lump sum or as a series of lump sums, the rule will operate on the smallest total payable. However a temporary assurance that has no surrender value and which does not run beyond the age of 75 is exempt from the 75% rule.

Temporary Insurances for 10 years or less

- The policy must secure a capital sum on death (or on death or earlier disability) and no other benefits.
- Participation in profits, surrender values, annuity options, increasable options, waiver of premiums on disability and disability benefits of a capital nature do not count as other benefits
- The policy must provide that any surrender value must not exceed the premiums paid
- For policies effected on or after 6/4/1979, the term must not be less than one Year

Whole of Life Assurances

- The policy must pay out a lump sum on death (or on death or earlier disability) and no other benefits
- Participation in profits, surrender values, annuity options, increasable options, waiver of premiums on disability and disability benefits of a capital nature do not count as other benefits
- Premiums must be payable at annual or shorter intervals for at least 10 years or until earlier death or disability
- The total premiums payable in any one year must not exceed twice the total premiums payable in any other year or one-eighth of the total premiums payable over the whole term (or over the first ten years where premiums are payable throughout life)
- The capital sum on death must be not less than 75% of the premiums which would be payable if death were to occur on the life assured's birthday. Where the sum assured can be paid as a lump sum or as a series of lump sums, the rule will operate on the smallest total payable.

Endowment Assurances

- The policy must pay out a lump sum on survival to the end of the term or death (or disability) within the term of the policy
- Other benefits may be included. Surrenders and bonus encashments are ignored
- The premiums must be payable at annual or shorter intervals for at least 10 years – or earlier death (or disability)
- The policy must have at least a 10 year term
- The total premiums paid in 1 year must not be higher than twice the total premiums payable in any other year – or 1/8th of the total premiums payable over the whole term
- The lump sum on death must be at least 75% of the total premiums that would be paid if the policy ran for its full term.   Where the sum assured is payable by instalments, the total of the instalments is used for this purpose – rather than any cash alternative offered at the time of a claim.   However, if a cash option is shown in the policy, this will be used.
- The 75% is reduced by 2% for each year by which the age of the life assured at the outset exceeds 55

Exempt Policies

- The main type of policy exempt from the qualifying rules is one with the sole objective of providing a lump sum on death or disability that is substantially the same as the outstanding mortgage on the policyholder's home or business premises

Other issues for Qualifying Policies

Joint Life Policies

- In the case of the 75% rule for whole life and temporary assurances for joint life policies – the 75th birthday is
  - Joint life 1st death – the oldest life
  - Joint life 2nd death – the younger life

Contingent Policies

- These are policies that are normally payable on the death of the life assured as long as another person (known as the counter-life) is still alive.
- These policies are treated in the same way as if payment of the lump sum on the life assured's death did not depend on the contingency

Family Income policies

- The same rules apply for this type of policy as applies to temporary assurance.
- A whole of life or endowment policy may include income benefits and if they do – they will qualify as long as either the basic assurance or the income benefit would have qualified separately
- This would also apply as long as the conditions for a whole of life or endowment assurance are met

Children's Policies

- It is possible for policies on the lives of young children to have the life cover deferred usually until age 16. To qualify – the policy must provide that if life cover is deferred to age 16 or another lower age – then any payment made on death during the deferred time must not exceed the total premiums that have been paid

Friendly Society Policies

- Different rules apply for Friendly Society Policies
- Policies must be for a term of at least 10 years
- Premiums must be level and payable at annual or shorter intervals for at least 10 years
- This term can be reduced to 5 years if the life assured is under 18 and the premiums are not more than £13 per annum
- Commutation of premiums is allowed after half the term or 10 years if earlier
- Commutation is also allowed if the policyholder moves out of the UK
- Any term or whole life sum assured must be at least 75% of total premiums to be paid up to age 75
- Any endowment sum assured must be at least 75% of total premiums payable, subject to the normal age 55 rule

Industrial Policies	There are special rules for Industrial policies – although the distinction between industrial and ordinary business was stopped for policies issued after 1995
Connected Policies	Where the terms of any policy state that it is to continue in force only as long as another policy also exists then neither policy is a qualifying policy unless if they had been constituted together as a single policy – that single policy would have been a qualifying policy
Extra Premiums and Debts	• The qualifying rules allow that any extra premiums charged for any exceptional risk of death or disability is ignored. • This only applies where there is evidence of an exceptional risk of disability or death. It does not apply if the extra charge was because of reluctance to use full underwriting either because the customer did not want to co-operate or because the insurer does not ask. • The 75% rule is also ignored for any loading for paying premiums more frequently than annually
Backdating	• If a policy is backdated by up to 3 months – it will be regarded as having been made on the date to which it is backdated. • However, if the policy is backdated more than 3 months it will be regarded as having been made on the date the contract was completed • This may result in a qualifying policy becoming non-qualifying - often because the one-eighth rule will be broken as a result of more than one year's premiums being payable in the first year
Reinstatement	• If a qualifying policy lapses due to non-payment of premiums – its qualifying status can be affected. • As long as it is reinstated within 13 months – it can continue to qualify but only if the policyholder gets the same policy as before. If, for example, the premium is increased due to a health problem disclosed on the declaration of health – then it is treated as a new policy. • If re-instatement happens after 13 months – then it will be treated as a new policy. This could mean that it does not meet the qualifying rules e.g. if there are less than 10 years to run

Substitutions and Variations	• Depending on the circumstances – the new policy could be qualifying or non-qualifying. If the changes are significant then HMRC would consider that these variations could make the policy non-qualifying whereas insignificant changes would not. • The conversion of a convertible term assurance policy into an endowment assurance or the addition or removal of a life would normally be significant. • Adding new illnesses to critical illness cover without charge is not a significant variation • The benefits of the policy after the alteration must be substantially the same as the original policy before the alterations were made. The premiums must not have been reduced to a nominal amount on the exercise of an option if that reduction is connected with a right to make partial surrenders
Change of the Life Assured	• HMRC considers that a change of the life assured is a fundamental change and makes it a new contract starting on the date of the change. This could result in the policy becoming non-qualifying if there are fewer than 10 years to run • If the policy is replaced by a new qualifying policy as a result of a change of the life or lives assured – the policies are treated as a single policy starting at the date of the first one for the purposes of income tax on the benefit. This reduces the chance of any chargeable gain arising by preventing the 10 year period starting again. • This only applies if no one receives any consideration, as a result of the replacement policy. • HMRC considers that if a salesperson receives commission or an adviser charge on the new policy this is consideration, so the rule does not apply. • HMRC also considers that a change of life assured as a result of a divorce is also consideration – unless it is as a result of a court order.

Offshore Policies	**A policy issued by a non-UK life office cannot be a qualifying policy unless** • **The life office becomes UK authorized and premiums are payable to a UK branch or** • **The policyholder becomes resident in the UK and the life fund income is chargeable to UK corporation tax.**
Certification	Any qualifying policy must either be certified by HMRC or it must conform to a standard form of policy that HMRC has certified as compatible with a qualifying policy. Policies do not need to be re-certified where there is a change of name of the insurer or a transfer of business to another insurer and the terms of the policy are unchanged. HMRC must be informed of the change. However, this is no longer required for new products launched from 6 April 2013.

5.2 Taxation of Life funds, onshore and offshore

- The life fund of a UK insurer is subject to taxation – generally the tax is paid at 20% on rental income, interest and offshore income
- UK dividends received within a life fund are taxed at 20%
- Realised Capital gains are taxed at 20% after indexation allowance
- This means that the fund has effectively borne tax at roughly the basic rate of income tax
- This tax cannot be reclaimed by the policyholder
- The tax treatment is modified by the I – E rules (Income minus Expenditure)
- This means that the life office can deduct the expenses of running the life fund from the income before paying tax on that income
- This can substantially reduce the overall tax bill – particularly for a new life office with heavy expenses but little income

- Protection life assurance funds used to be included in the I – E system. From January 2013 they were removed from this system and are treated as other trading entities. This resulted in a slight increase in the cost of such cover.

Offshore Life Funds

- There has been a large increase in business written by UK residents with non-UK based insurers
- This is generally done via subsidiaries of well-known UK life offices - and based in countries such as the Isle of Man, Ireland, Luxemburg and the Channel Islands

The main advantage of offshore policies is that the countries generally impose little or no tax on the income and gains of the underlying life fund.

- This is often called a gross roll-up, which is valuable to a higher rate taxpayer.
- Generally – the only tax suffered by the insurance funds is a small amount of non-reclaimable withholding tax
- This is in contrast to an onshore life policy where the fund suffers tax at 20% on most income and gains

When an offshore bond is surrendered by a UK policyholder – it is chargeable to income tax on the gain at basic, higher or additional tax rates depending on the tax payer's tax situation

5.3 Capital Gains Tax and life assurance policies

Gains made on life insurance policies are primarily subject to income tax.

Second Hand Policies

- However, there could be a CGT charge on the realized gain on a policy if the disposer is not the original owner and they acquired the policy for money or money's worth.

Chargeable Gains are where Higher and Additional rate tax payers are liable to pay income tax on payments they receive from all non-qualifying policies put into place after 19/3/1968

This charge does not apply to exempt policies such as a decreasing term assurance policy with the objective of paying off a mortgage on death within the term and where the sum assured matches the outstanding mortgage and decreases in line with the decreasing mortgage balance.

How to establish if a "Chargeable Event" has occurred

- **Non-qualifying policies**
  - Death of insured(s) – if it gives rise to a benefit
  - Maturity
  - Surrender
  - Certain part surrenders and part assignments
  - Policy loan
  - Assignment for money or money's worth

- **Qualifying policies**
  - Death of insured(s)– if it gives rise to a benefit
  - Maturity

  (These 2 situations are only chargeable events if the policy is made paid-up within 10 years or ¾ of the term if sooner)

  - Surrender
  - Certain part surrenders and part assignments
  - Policy loans at a non commercial rate of interest
  - Assignment for money or money's worth

  (The last 4 events are only chargeable if the event happens within the above period or if the policy has been made paid-up during that time)

- Since 6 April 2013 premiums payable by an individual to qualifying policies are restricted to £3,600 per annum
- The time limits are from inception of the policy or from any variation where the premiums are increased.
- Assignation of the policy for a mortgage is ignored as are assignations of a policy between spouses or civil partners living together. A policy assignment in connection with a divorce or pre-nuptial settlement is an assignment for money's worth, unless it's as a result of a divorce court order, then it is not for money's worth – even if the court is just confirming an agreement reached by the divorcing couple.
- A loan from the policy to buy a life annuity where the interest is eligible for tax relief is not a chargeable event
- Payment of critical illness benefit is not a chargeable event
- If a policy is assigned on or after 6 April 2013 it will become either a non-qualifying policy or a restricted relief Qualifying policy depending on the nature of the assignment

Calculation of gain

Chargeable events can lead to a chargeable gain as follows:

- **On death.** If the surrender value before death plus any relevant capital payments exceeds the premiums paid plus the total gains on previous chargeable events
- **On maturity or surrender.** If the amount paid out plus any relevant capital payments exceeds the premiums paid plus the total gains on any previous chargeable events. Where the sum assured is payable by instalments, the amount taken for the calculation is the capital value of the instalments

- **On assignment.** If the consideration, plus any relevant capital payments exceeds the premiums paid plus the total gains on previous chargeable events.

"Relevant Capital Payments" are any benefits of a capital nature paid under the policy before the chargeable event. Gains also occur on certain part surrenders, including bonus surrenders. (The part surrender rules can be quite complicated and are not covered in this text). "Consideration" means any money or other value that is paid by the new owner in return for transferring ownership of the policy.

Taxation of the gain

When a chargeable gain arises – it is taxed at the difference between basic rate tax (20%) and either higher rate tax (40%) or additional rate tax (45%) – so effective rates of either additional 20 or 25% tax. If the person is not a higher or additional rate taxpayer after the gain is added to their income then there is no actual tax due to be paid, as this is covered by the basic rate tax credit for tax already paid within the life company's fund.

The tax is chargeable to the beneficial owner of the policy. If the policy is mortgaged then the mortgagor is chargeable and if it is under trust there are special rules

Trust policies

Where a policy in a trust is subject to a tax charge, then the taxation and who pays it depends on whether the person who created the trust is alive or not after the event and then where the trustees are resident for tax purposes.

- The gain is treated as part of the income of the person who created the trust as long as
    - The person was alive and UK resident in the tax year in which the chargeable event occurs
    - They can recover any tax paid from the trustees (unless the provisions of the trust prevents this)
    - This would also be the position if the chargeable event takes place in the tax year in which the person who created the trust dies

- The trustees are chargeable on the gain if
    - The chargeable event happens in a tax year after the settlor of the trust has died and 1 or more of the trustees are resident in the UK
    - The trustees are also liable if the settlor is still alive but resident outside the UK immediately before the chargeable event
    - The tax is charged at the trust rate i.e. 45% which means additional tax of 25% would be due on gains in excess of £1000. The 1st £1000* of trust income is taxed at 20%. (* may be reduced if the settlor has created more than 1 trust)

- If the trustees are not resident in the UK – any UK beneficiary receiving a benefit under the trust from the gain will be taxable on that amount at their tax rates, but without top-slicing relief.

These rules do not apply to policies effected on or before 16 March 1998, where the trust was also created prior to that date and the creator of the trust died before then. For these cases, there is no one on whom to make the tax charge, but the policy must not have ben varied after 16 March 1998 so as to increase the benefit or to extend the term.

Also, these rules do not apply to a bare / fixed / absolute trust, where the gain is assessed as the income of the beneficiary (subject to the operation of the 'parental settlement' rules).

Administration of the tax

The life office is not responsible for the taxation of chargeable gains and they will make the policy payments without deduction of tax other than the normal fund tax.

However, they must send to the Policyholder a chargeable event certificate which will provide details of the gain made.

The person who is chargeable is responsible for declaring the gain on their tax return for the year in which the chargeable event occurred.

Pension Policies

Pension Policies are not included in the chargeable gains regime.

When a client elects to take an income, the regular pension payments to the client are subject to income tax which will be deducted by the pension provider at the appropriate rate under the PAYE system. A non taxpayer can complete form R89 which would allow for gross payment of the pension.

Non-pension group life policies

Certain non-pension group life policies are exempt from the chargeable gains rules.

In theory – any other type of non-pension group life policy could be subject to chargeable gains, but in practice this would only be on a 2nd or subsequent death claim. As most of these plans only last a year or two – this would be quite rare.

Second hand policies

- There is a market for selling "second hand" life policies
- The assignation of the policy by the seller to the buyer may be a chargeable event, as an assignment for money
- This could lead to a chargeable gain
- A policy is deemed to be second hand if an investor bought the policy from the previous owner
- When the buyer of a 2nd hand policy receives the benefits – on maturity, death of the life assured or of a further sale – there could be a charge to CGT because this is a disposal for that purpose.

- The gain is calculated by deducting the purchase price (plus expenses and premiums paid by the disposer) from the proceeds whether this arises from maturity value, death claim value or sale price.
- CGT is not paid on chargeable gains which have already been considered for income tax.

Assignments

An assignment might be a chargeable event if it is for consideration. An assignment that was not for consideration (e.g. a gift) might be subject to IHT.

Commission

If an adviser is paid commission by a life office for selling a protection policy this is subject to income tax for an individual or corporation tax if the adviser is a company. The life office will pay the commission gross and the recipient has to declare this as part of their earnings on their tax return. If the adviser is an employee of the life office it will have to deduct income tax under PAYE and National Insurance. Commission for arranging insurance is exempt from VAT.

5.4 Inheritance tax and life assurance

Basic inheritance tax planning will include

- Funding for the tax
- Making lifetime gifts to utilize the lifetime exemptions
- Making a will so that assets are not distributed under the laws of intestacy – which may not be tax efficient

Life policies are often used for IHT planning

Inheritance tax funding

IHT is a tax payable on death or on certain lifetime gifts. Whole of life policies are often used to provide for IHT planning.

- IHT payable on death can be a major liability – and it is often difficult to find the cash to pay the tax
- The deceased's legal personal representatives must deliver an account of all the deceased's property before a grant of representation can be obtained
- They are due to pay the tax due on delivery of the account – unless any of it can be paid in instalments
- They will have to pay the tax before they can get the grant
- This can cause problems as the assets of the estate – some of which could be used to pay the tax – cannot be released as the legal personal representatives cannot prove their title without the grant – and they can't get that till the tax is paid.
- A ready source of liquid cash outside the estate can provide the funds to pay the tax and thus allow the legal personal representatives to obtain the grant and release the assets in the estate.

- A whole of life policy is tailor made to provide cash on death whenever it occurs
- Many whole of life policies are written to fund IHT
- The policy should be written under trust for the benefit of the heirs to the estate so that the policy is not an asset of the estate
- This means that there will be no IHT on the policy proceeds and payment can be made to the surviving trustees very soon after the death. Thus not having to wait for the grant
- The trustees then have liquid cash to pay the beneficiaries who can then loan the funds back to the legal personal representatives so that they can pay the tax immediately

Preserving the Estate

The legal personal representatives often have to sell assets of the estate in order to meet the tax liability – usually by arranging a short term loan. This may not be in line with the individual's wishes.

This can often be avoided by arranging a life policy (under trust) to meet the IHT liability. This allows the tax liability to be paid quickly and then the estate assets to be distributed according to the deceased's wishes.

Joint Life Policies

For UK domiciled spouses/civil partners – the IHT liability usually arises on the 2nd death as generally one partner leaves the bulk of the estate to the other. In that situation, there is no IHT liability on 1st death – the problem arises on the 2nd death

On 2nd death the original estate plus the additional estate inherited on the 1st death will be tested for IHT liability.

- Most IHT plans are written on a joint life, 2nd death basis
- The life policy should be written under trust which means that it will pay out on the 2nd death and provide the cash needed to pay the IHT due
- 2nd death policies are usually cheaper than on single life policies – because the payment is deferred to the second death.

Sum assured

- The sum assured should match the anticipated tax liability
- This has to take into account the fact that no one knows exactly when death will happen and there could be changes in the estate values.
- The tax liability should be calculated using current rate and on the assumption that death could happen immediately
- Until recently, it was assumed that the Nil Rate Band would be indexed. The current Chancellor has fixed the NRB until 2020/21
- The tax liability could increase over the sum assured if the value of the estate outstrips the current NRB.
- One way to work round this is to effect a with-profit or unit linked policy with enough investment content for the amount payable to increase each year to meet the increased liability
- Alternatively – many policies offer the facility to index-link the life cover

Premiums

- Premiums for policies intended to pay IHT liability are usually paid monthly or annually
- Although payment of these premiums are gifts – they are normally exempt under the £3,000 annual or normal expenditure from income exemption
- These exemptions may not apply if the premiums were paid by single premium
- If the gift is not exempt as above it would be a chargeable lifetime transfer if a discretionary trust is used, or a potentially exempt transfer if an absolute/bare trust is used.

Regular Gifting using life policies

As well as using life policies to meet the IHT liability – they can be used to take wealth out of the estate on a regular basis.

- A life policy is effected with a premium that will fall into the available exemptions. The policy should be written under trust for the benefit of the selected beneficiaries
- This means that a considerable sum can be built up outside of the estate for IHT purposes
- Endowment or whole of life policies can be used for this
- A unit linked endowment would pay out the value of the units on maturity or the higher of the value of the units and the guaranteed sum assured on death
- This type of policy can often have an extension option which can be used if the life assured is still alive at the end of the term
- A whole of life unit linked policy can also be used
- As the policy will be subject to underwriting – the life assured needs to be in reasonable health for their age
- As the policy is written under trust, on death of the life assured – the proceeds will be paid out to the trustees to pass to the beneficiaries and no IHT liability arises in the deceased's estate.
- For IHT purposes – the client gifts each premium, as and when it is paid. The client could limit premiums to £3000 per annum to keep the gift within the £3000 annual exemption - as long as it has not already been used in the tax year.
- This method allows for large amounts to be built up over the years – outside the estate and with no IHT liability. The cumulative effects of the £3,000 moving out of the estate over the years – also reduces the IHT payable e.g. if a £3,000 premium is paid every year for 15 years, the estate will have been reduced by £45,000 – thus saving IHT of £18,000.

Normal Expenditure from Income Exemption

As well as the Annual Exemption Allowance – there is also the expenditure from income exemption – and this could allow a wealthy client to gift a great deal of money.

The rules for this exemption to apply are

- The gifts must be regular
- Out of income
- And must be such as not to affect the donor's normal standard of living, i.e. they must be able to maintain that normal standard of living from their remaining income.

A life policy should meet these rules due to the regular premiums. Care must be taken to ensure that the "not to affect the donor's normal standard of living" rule is met, for all premiums paid into the life of the policy and not just at inception.

This exemption can be used along with the £3,000 annual exemption.

  - If the client was quite wealthy then quite high amounts can be used – again saving IHT liability.
  - E.g. £3,000 annual exemption plus £15,000 from normal expenditure – taking £18,000 a year out of the estate.
  - Over 10 years this would total £180,000 and save IHT of £72,000

Joint Life Policies

- Each spouse has their own annual exemption
- For a joint life 2nd death policy – it can be set up with each spouse paying a share of the premiums so that they can each use their own annual exemption
- Each spouse has to pay the premium from their own account or from a joint account.
- Each spouse has to meet the exemption conditions individually
- It is possible for one spouse to make a gift to the other so that they can use their exemption. However each gift must be unconditional and not income
- When the first spouse dies the surviving spouse will only have their own personal exemptions.

Insuring Lifetime Gifts

Term assurances are ideal for IHT protection for lifetime gifts.

Tax is payable on lifetime gifts where the client gifts more than his nil rate band in the 7 years before his death. The tax liability reduces as follows;

Years survived until death	Inheritance Tax Payable
0 – 3	100%
3 – 4	80%
4 - 5	60%
5 - 6	40%
6 -7	20%
7 years +	nil

- A 7 year decreasing term assurance can be used for gifts which, together with other gifts in the 7 years before his death exceed the NRB
- This can be effected by the donor using an absolute trust for the donee with the premiums either being exempt (using annual or normal expenditure exemptions) or a series of small PETS. Or

- The donee could write the policy on the life of the donor – with the potential IHT liability creating the insurable interest. The donor could then make gifts to allow the donee to pay the premiums or the donee could pay them themselves.
- A special 7 year term assurance known as a Gift Inter Vivos may be available, although these products are no longer widely provided. The sum assured is level for 3 years then decreases in line with taper relief.

Protecting the estate

- Insuring the Inheritance tax on a lifetime gift payable on death within 7 years is not the whole story.
- Although the policy would pay the tax due on the gift (and after taper relief) the lifetime gift has the effect of reducing the Nil Rate Band available for the estate. Lifetime gifts are the 1st to be set against the clients nil rate band, before the rest of his death estate is considered.

The donor might want a policy to protect the beneficiaries of the estate against their extra IHT.

- A 7 year level term assurance policy could be considered because the tax liability does not decrease during the 7 years
- Or a whole of life policy with a sum assured to match the total tax on the estate could be considered
- The policies should be written under trust – for the beneficiaries of the estate with the executors as trustees.

Jointly Held Property

An asset held under a **joint tenancy** will pass automatically to the survivor on the death of the first joint tenant

Usually, joint tenants are married/civil partnership and so the spouse's exemption will apply,

If the asset is held as **tenants in common** – then each person's share will be passed on as detailed in the will of the tenant in common. If it passes to a UK domiciled spouse or civil partner it will be exempt under the spouse's exemption. If not, then it will be subject to IHT.

Inheritance Tax Threshold (nil rate band)

The Inheritance Tax threshold (or 'nil rate band') is the amount up to which an estate will have no Inheritance Tax to pay.

If the estate - including any assets held in trust and gifts made within seven years of death - is more than the threshold, Inheritance Tax will be due at 40 per cent on the amount over the nil rate band.

The threshold has been fixed at £325,000 until 2020/21.

Nil Rate Bands and Wills

Since 9 October 2007 – it's possible to transfer any unused portion of the deceased's Nil Rate Band if one of a married couple or civil partnership dies. The NRB at the date of the 2^{nd} death is used

Partial transfers are also possible

- if the deceased spouse had used up half of his nil rate band on death – then half would be available to transfer
- The amount available to transfer to the survivor would then be 50% of the NRB that applies at the time of the 2^{nd} death. The surviving spouse or civil partner has their own nil rate band in addition to this.

For larger estates, it makes sense to redistribute the total estate between husband and wife to make sure that each is able to use their NRB by making lifetime gifts.

Main residence nil-rate band

From 6 April 2017, a main residence nil-rate band can apply, in additional to the 'normal' nil rate band.

It will apply where the deceased's had an interest in a residential property, which has been their residence at some point and is left in the estate to one or more direct descendants on death. A direct descendant will be a child (including a step-child, adopted child or foster child) of the deceased and their lineal descendants.

Also, where the deceased owned a residence on or after 8 July 2015, but downsized to a less valuable residence or ceased to own such a residence (i.e. they sold or gifted it), the value of the former residence will still be available provided the deceased left the smaller residence, or assets of equivalent value, to direct descendants. However, the total amount available cannot exceed the maximum available residence nil-rate band.

The value of the main residence nil-rate band for an estate will be the lower of the net value of the interest in the residential property (after deducting any liabilities such a mortgage) or the maximum amount of the band. The maximum amount will be:

- £100,000 for 2017 to 2018
- £125,000 for 2018 to 2019
- £150,000 for 2019 to 2020
- £175,000 for 2020 to 2021

However, where the net value of the estate (after deducting any liabilities but before reliefs and exemptions) is above £2 million, the residence nil-rate band will be reduced by £1 for every £2 that the net value exceeds that amount.

Only one residential property will qualify for the nil rate band. However, where an estate includes an interest in more than one residential property, the legal personal representatives of the estate will be able to nominate which residential property should qualify. A property which was never a residence of the deceased, such as a buy-to-let property, will not qualify.

It will be possible to transfer any unused residence nil rate band to a surviving spouse or civil partner, in the same way that the existing nil-rate band can be transferred. And the transfer will still be possible where the first death occurs before 6 April 2017, providing that on their death, the qualifying conditions were met.

Inheritance Tax exemptions and reliefs

Even if an estate is over the threshold, an individual can pass on assets without having to pay Inheritance Tax. Examples include:

- Spouse or civil partner exemption. The estate usually doesn't owe Inheritance Tax on anything left to a spouse or civil partner who has their permanent home in the UK - nor on gifts made to them during the individual's lifetime - even if the amount is over the threshold.
- Charity exemption. Any gifts made to a 'qualifying' charity - during the individual's lifetime or in their will - will be exempt from Inheritance Tax. A donation to charity in their will may also reduce the rate that tax is paid at.
- Potentially exempt transfers. If the individual survives for seven years after making a gift to someone, the gift is generally exempt from Inheritance Tax, no matter what the value.
- Annual exemption. Up to £3,000 can be given away each year, either as a single gift or as several gifts adding up to that amount – an individual can also use their unused allowance from the previous year but must use the current year's allowance first.
- Small gift exemption. Small gifts of up to £250 can be given away each year to as many individuals as they like tax-free. However, this exemption cannot be used to exempt part of a larger gift.
- Wedding and civil partnership gifts. Gifts to someone getting married or registering a civil partnership are exempt up to a certain amount.
- Business, Woodland, Heritage and Agricultural Relief. If the deceased owned a business, farm, woodland or National Heritage property, some relief from Inheritance Tax may be available.

Protection Learning Outcome 5 (PROT5) – End of Module Test

Multiple Choice Questions

Question	Answer	
5.1 - Lee Bradley, a Higher Rate Tax payer surrendered a non qualifying policy which gave a gain of £10,000. He had held the policy for 5 complete years. What tax is payable on the gain?	A.	£2,000
	B.	£1,800
	C.	£800
	D.	£360

5.2 - Martine has a gross income of £25,000. She makes a gain of £8,000 on her non qualifying policy. The encashment happened after 8 ½ years. What is the tax payable on the gain?	A.	None
	B.	£1,600
	C.	£200
	D.	£400

5.3 - A widow aged 49 has an estate valued at £350,000 above the nil rate band. She now wants to leave this to her two children. Which Life Assurance product, if any, should she effect to protect against any IHT liability that may arise?	A.	Decreasing term assurance
	B.	Level term assurance
	C.	Low Cost Endowment Assurance
	D.	Whole of Life Assurance

5.4 - Mrs Evans has died leaving an estate with a value of £635K. Half of this has been left to her husband and the remainder to her children. If the IHT threshold is £325K, How much IHT, if any, will need to be paid?	A.	£63,500
	B.	£0
	C.	£127,000
	D.	£124,000

5.5 - Which of the following would form part of the calculation for someone's IHT liability?	A.	£50k gift to a friend made 6 years before death.
	B.	A transfer to a spouse 6 years before death.
	C.	A donation to a registered charity made 6 years before death.
	D.	The proceeds from a Life Assurance Policy written under trust for a named beneficiary.

5.6 - Which type of policy does the qualifying rule 'The policy must provide that any surrender value must not exceed the premiums paid' apply to?	A.	Whole of life assurance.
	B.	Temporary insurance for a term of 10 years or less.
	C.	Temporary insurance for a term of more than 10 years.
	D.	Endowment assurance.

5.7 - Which of the following best describes the method of transfer of ownership and the IHT implications for assets owned jointly as tenants in common by a husband and his wife on the first death of one of them?	A.	The assets will pass automatically to the survivor. Provided that both are UK domiciled, the spouse's exemption will apply.
	B.	The assets will pass automatically to the survivor. Provided the survivor is UK domiciled, the spouse's exemption will apply.
	C.	The deceased's share of the assets will be passed on according to their will or the laws of intestacy if they have not left a valid will. Provided the estate passes to the survivor spouse who is UK domiciled, the spouse's exemption will apply.
	D.	The deceased's share of the assets will be passed on according to their will or the laws of intestacy if they have not left a valid will. Provided that both are UK domiciled, the spouse's exemption will apply.

5.8 - How should a whole of life policy be set up to enable it to settle the IHT due on an individual's estate?	A.	The policy should be written under trust for the benefit of the heirs to the estate.
	B.	The policy should be written under trust for the benefit of the deceased.
	C.	The policy should be written without the use of a trust.
	D.	The policy should be written under trust for the benefit of the legal personal representatives.

5.9 - Which of the following most accurately describes the taxation of the life fund of a UK insurer?	A.	Generally the tax is paid at 20% on rental income and interest. Offshore income is taxed at 40%.
	B.	Generally the tax is paid at 20% on rental income. Interest is taxed at 10%. Offshore income is taxed at 40%.
	C.	Generally the tax is paid at 20% on rental income. Interest is taxed at 10%. Offshore income is taxed at 20%.
	D.	Generally the tax is paid at 20% on rental income, interest and offshore income.

5.10 - Which of the following best describes chargeable events for qualifying policies?	A.	Death (if it gives rise to a benefit), maturity, surrender, certain part surrenders and part assignments, policy loans at a non commercial rate of interest, assignment for money or money's worth.
	B.	Death (if it gives rise to a benefit), maturity - these 2 situations are only chargeable events if the policy is made paid-up within 10 years or 3/4 of the term if sooner. Surrender, certain part surrenders and par assignments, policy loans at a non commercial rate of interest, assignment for money or money's worth - these 4 situations are only chargeable events if the event happens with the above period or if the policy has been made paid-up during that time.
	C.	Death (if it gives rise to a benefit), maturity, surrender, certain part surrenders and part assignments, policy loans, assignment for money or money's worth.
	D.	Surrender, certain part surrenders and part assignments, policy loans at a non commercial rate of interest, assignment for money or money's worth - these 4 situations are only chargeable events if the policy is made paid-up within 10 years or 3/4 of the term if sooner. Death (if it gives rise to a benefit), maturity - these 2 situations are only chargeable events if the event happens within the above period or if the policy has been made paid-up during that time.

- **End of Questions** -

Answers

Question	Answer	
5.1 - Lee Bradley, a Higher Rate Tax payer surrendered a non qualifying policy which gave a gain of £10,000. He had held the policy for 5 complete years. What tax is payable on the gain?	A	£2,000
5.2 - Martine has a gross income of £25,000. She makes a gain of £8,000 on her non qualifying policy. The encashment happened after 8 ½ years. What is the tax payable on the gain?	A	None
5.3 - A widow aged 49 has an estate valued at £350,000 above the nil rate band. She now wants to leave this to her two children. Which Life Assurance product, if any, should she effect to protect against any IHT liability that may arise?	D	Whole of Life Assurance
5.4 - Mrs Evans has died leaving an estate with a value of £635K. Half of this has been left to her husband and the remainder to her children. If the IHT threshold is £325K, How much IHT, if any, will need to be paid?	B	£0
5.5 - Which of the following would form part of the calculation for someone's IHT liability?	A	£50k gift to a friend made 6 years before death.
5.6 - Which type of policy does the qualifying rule 'The policy must provide that any surrender value must not exceed the premiums paid' apply to?	B	Temporary insurance for a term of 10 years or less.

5.7 - Which of the following best describes the method of transfer of ownership and the IHT implications for assets owned jointly as tenants in common by a husband and his wife on the first death of one of them?	C	The deceased's share of the assets will be passed on according to their will or the laws of intestacy if they have not left a valid will. Provided the estate passes to the survivor spouse who is UK domiciled, the spouse's exemption will apply.
5.8 - How should a whole of life policy be set up to enable it to settle the IHT due on an individual's estate?	A	The policy should be written under trust for the benefit of the heirs to the estate.
5.9 - Which of the following most accurately describes the taxation of the life fund of a UK insurer?	D	Generally the tax is paid at 20% on rental income, interest and offshore income.
5.10 - Which of the following best describes chargeable events for qualifying policies?	B	Death (if it gives rise to a benefit), maturity - these 2 situations are only chargeable events if the policy is made paid-up within 10 years or 3/4 of the term if sooner. Surrender, certain part surrenders and par assignments, policy loans at a non commercial rate of interest, assignment for money or money's worth - these 4 situations are only chargeable events if the event happens with the above period or if the policy has been made paid-up during that time.