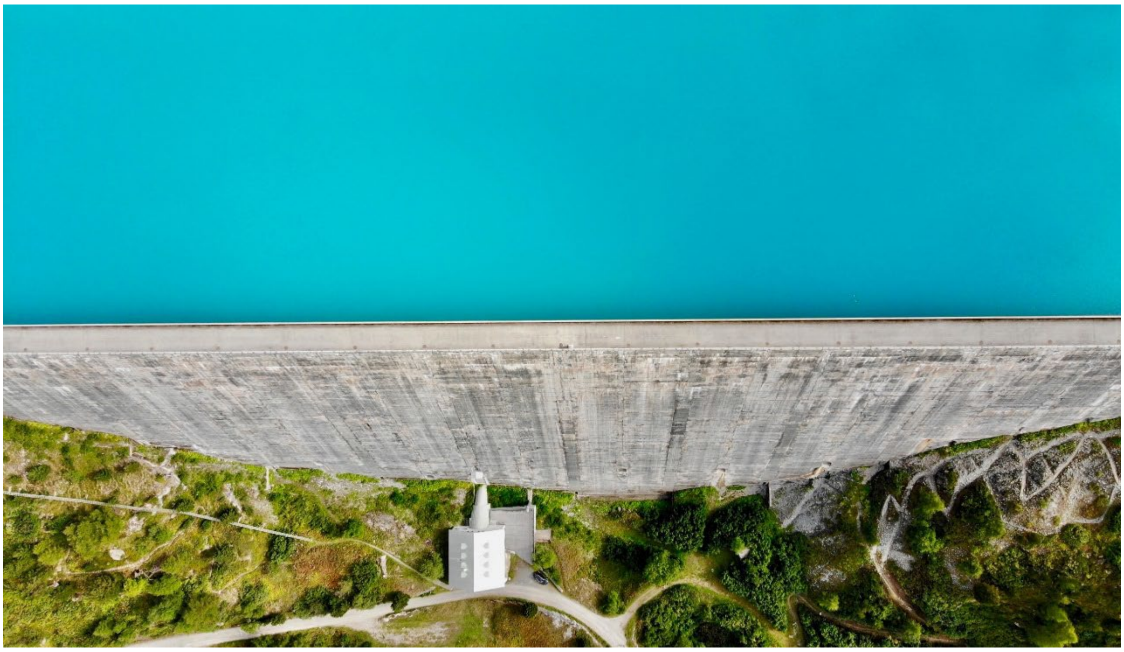
Life assurance – the guaranteed way to cover UK inheritance tax liabilities?



Life assurance has proved itself to be a dependable and a non-controversial way to fund for future UK Inheritance Tax (IHT). No complex planning required, just get through the medical and pay the premiums. Is it really as simple as this?

This Insight looks at the typical uses of, advantages and disadvantages of life assurance for IHT planning. Life assurance, particularly for non-UK domiciliaries (non-doms), can be a simple way of providing for IHT exposure on UK residential property.

Life assurance is far from straightforward when it becomes a valuable part of more complex estate planning; so if you have any questions, please don't hesitate to contact us.

Types of policy typically encountered

There are several lump sum plans available (Discounted Gift Trusts and Loan Trusts being the main ones) but these are essentially investment based plans with very little insurance content. The most commonly used types of life assurance are:

Term Assurance – Lump sum payable on death, with the term typically set at 10, 15 or 20 years, although it is possible to take out policies for shorter time periods.

Whole of Life – Lump sum payable on death but no set term. Policies can be on a *guaranteed basis,* where the premium and sum assured do not change. Policies on a *reviewable basis* are likely to see the premium increase or the sum assured decrease after the 10th anniversary.

Gift inter vivos – Covers the tax becoming due on a failed Potentially Exempt Transfer (PET).

Convertible term – Term assurance policy which can convert into a Whole of Life in the future

Cost of £1,000,000 in life assurance cover

The type and duration of the life assurance policy will depend on the IHT liability it is covering. Premiums will vary significantly from one type to the other. The adjacent table gives some indicative premiums.

There are several life companies (both onshore and offshore) offering high-level cover, which is suitable for IHT planning and it is therefore important to work with an advisor, such as Edison, who has visibility over the entire market. Also premium rates do change regularly.

The figures shown opposite are whole of market, before individual medical underwriting and exclude commission. Your client may choose to include commission, which would increase the premium, or agree a fixed fee.

Table1. Annual premiums

		Term			
Age	Type	10 years	20 years	Whole of Life	Gift inter vivos
40	Individual	£424	£462	£7,270	£366
40	Joint life last survivor	£218	£268	£5,900	n/a
50	Individual	£907	£1,097	£11,071	£687
50	Joint life last survivor	£452	£631	£8,599	n/a
60	Individual	£2,396	£3,369	£16,401	£1,773
60	Joint life last survivor	£1,272	£1,915	£12,309	n/a

Based on £1m death benefit, nil commission and not subject to underwriting.

Assessing suitability

The suitability of assurance policies will depend on what an individual wants to achieve and their circumstances.

The table below is not an exhaustive list of the factors taken into account. Instead it shows a summary of the advantages and disadvantages of each policy type.

Table 2. Advantages and disadvantages

Type of plan	Advantages	Disadvantages
Term	Relatively cheap when compared to whole of life and does what it says on the lid i.e. it protects against death occurring during a certain term. Therefore it can be attractive for a non-dom likely to be in the UK for a pre-defined period of time and looking to cover liability to IHT on a UK property or a family looking to cover IHT liability until their children are ready to start receiving gifts of assets directly.	The premiums are relatively cheap for a reason – there is statistically unlikely to be a pay out! Plans can change e.g. a non-dom might be in the UK for longer than anticipated. The value of the underlying asset, which the cover is designed to protect, may rise during the term leaving the policyholder underinsured.
Guaranteed whole of life	Although relatively expensive, providing the premiums are maintained throughout life, the sum assured will definitely pay out. Can be thought of as a very long term and tax efficient way of covering some of an IHT liability.	Expensive and so many policies do not go to full term, which conversely help to subsidise the ones that do. Remember the time value of money. A £1m sum assured now is not the same in real terms as the £1m that will be paid out in say 30 years' time. IHT liability is likely to increase over time with the value of underlying assets and so the cover taken at say age 50 may be inadequate if death occurs at say 85.
Reviewable whole of life	Relatively cheap – in fact often cheaper than a comparable 10 year term policy	Premiums often increase sharply after 10 years but providing this is clear at outset there is no need to discard reviewable.
Gift Inter Vivos (GIV)	It does the job that is intended i.e. covers a pre-determined liability and total premiums are known at the outset	Practical point. There are currently only 2 providers offering GIV cover so the premiums may not be as competitive although it is possible to mimic GIV with a series of short-term policies.

Whole of Life (WOL) and the science behind the guaranteed return

Guaranteed WOL is what it says – guaranteed. Providing premiums are maintained for the rest of the insured's life, the sum assured will pay out on their death.

For this reason and the fact that life expectancy tables are regularly published, it is possible to calculate the likely return that the sum assured will represent when paid to the beneficiaries of the life insured following their death

Example:

John is aged 50 and in good health. He intends to provide £1m for his children in the future following his death. John's life expectancy is c. 31 years. The premium for a healthy 50-year-old is approximately £11,071 pa and so the return to normal life expectancy is approximately 6.23% p.a. compound.

In other words, if John set up a savings plan today for £11,071 pa and received an annual return of 6.23% pa his children would receive £1m after 31 years.

This return will almost certainly be paid to his children free of all taxes.

There will be no income tax on a guaranteed WOL policy as there is no investment content and there is also unlikely to be IHT as the policy would normally be held in a discretionary trust and would therefore not form part of the policyholder's estate on death. Nonetheless, the payment of premiums to a discretionary trust is a transfer of value and must be covered by an appropriate IHT exemption (such as the

£3,000 annual exemption or gifts out of surplus income) otherwise, if exceeding the Nil Rate Band, an immediate charge to IHT may arise on the payment of the premiums.

Of course looking at this another way, £1m today is not the same as £1m paid out in 31 years' time. If the estimated IHT liability is £1m today it is likely to be far higher 31 years into the future. And if John lives beyond 81 then the return starts to diminish.

The next table looks at WOL equivalent returns based on current premiums.

Table 3. Whole of Life equivalent rates of return

			Equivalent Return (p.a.)		
Age	Term	Premium	Male	Female	Joint
40	Individual	£7,270	5.41%	4.71%	-
	Joint life last survivor	£5,900	-	-	5.47%
50	Individual	£11,071	6.23%	5.22%	-
	Joint life last survivor	£8,599	-	-	6.45%
60	Individual	£16,401	8.32%	6.63%	-
	Joint life last survivor	£12,309	-	-	8.59%

Based on £1m death benefit, nil commission and not subject to underwriting.

Although it is no longer permissible to differentiate between male and female lives in terms of premium, females generally live longer yet now pay equivalent premiums. Therefore they are likely to pay these premiums for longer- hence the effective returns on their policies are likely to be lower.

Is it better to self-fund?

On the basis of the results in this table is it better to self- fund? Although the returns above may be achievable, they would certainly not be guaranteed, and the impact of fees would need to be considered too. Furthermore, even if the required returns can be achieved, can they be delivered tax free?

Whole of Life and non-doms

For non-doms wishing to mitigate IHT on UK residential property there are few remaining solutions. A WOL policy can provide a solution, insuring the value of the UK property x 40% and is (one hopes) immune from future legislative change. It may be possible to build in some indexation to the lump sum to keep pace to an extent with increases in the underlying property value.

Guaranteed WOL policies are generally written by insurance companies resident in the UK and can therefore constitute a UK situs asset for IHT purposes. A non-dom will therefore need advice on an appropriate trust for their estate to avoid UK IHT on the policy payout.

The importance of thoughtful advice

Edison Wealth Management is an independent fee-based financial planning firm. In other words, we do more than just broker life cover, we provide

independent advice to help you and your clients achieve the underlying objective(s).

Life assurance is far from straightforward when it becomes a valuable part of more complex estate planning.

At Edison, we understand personal tax, estate and inheritance tax planning, so that we are able to work *with you* to ensure any life assurance we recommend enhances the planning you are putting in place for your clients.

We can provide you with support on:

- Suitability of various product types and how they meet the objective(s)
- Competitive premiums
- Review of existing life assurance cover

Important information

The above is a simplification of the legislation. It does not constitute advice. The views expressed above are subject to changes in legislation. Please note that estate planning and trusts are not regulated by the Financial Conduct Authority. The Financial Conduct Authority does not regulate tax advice.

To get in contact to discuss any of the above, please contact:

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