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WHEN IT MATTERS MOST

Life Insurance and Pensions – Mitigating Inheritance Tax

Life Insurance Policies

For individuals of insurable age and health, taking out a life insurance policy can be a crucial succession planning tool.

Death in service benefits paid on death through employment can serve a similar purpose. For couples, on the first death, a policy can pay liabilities such as a mortgage and reduce the effect of lost income. On the second death, it can pay the Inheritance Tax (IHT).

A life insurance policy pays out a lump sum payment on death. If it has been written in trust or nominated to a third party the payment is outside the taxable estate. It is a discretionary payment made in accordance with any written request to the Trustees or the company administering the policy. You should therefore check with the policy administrator that you have completed a nomination form.

If you have nominated a particular individual to receive the lump sum payment, such sum would aggregate with the value of their estate and increase the charge to IHT on their death. This can be inefficient for IHT purposes so it may be better to use a Pilot Trust (see below). Life insurance policy premiums paid to a third party are gifts for IHT purposes. Therefore the total premiums in the 7 years prior to death will reduce the Nil Rate Band allowance (currently £325,000) before IHT is due.

Pilot Trusts

It is possible in most cases to request that the Trustees of the policy pay the death benefits into a trust rather than directly to an individual. These trusts are commonly referred to as "Pilot Trusts" as they are set up in lifetime but remain dormant unless and until a lump sum is paid to the Trustees on death.

A surviving spouse would usually be one of the beneficiaries of the Pilot Trust (along with any children). If also a Trustee, the surviving spouse would be able to co-manage the investment and distribution of funds, but the funds belong to the trust and will not, therefore, be part of their estate for IHT purposes. The Pilot Trust can make an interest-free loan to the surviving spouse, repayable on death and deductible against their taxable estate. However, Pilot Trusts do incur an IHT charge of 6% every 10 years on the value of the trust fund over its Nil Rate Band allowance. It should also be noted that Pilot Trusts formed after 6 October 2020 will need to register on the Trust Registration Service maintained by HMRC. The Trustees will be required to give some basic information about the persons involved in the trust (the settlors, beneficiaries, and anyone else who exerts control over the trust).

Pensions

Pensions are extremely tax-efficient and a way of providing much needed financial security in old age. In most cases, the payment of your pension is not subject to IHT.

You can usually nominate people to benefit by completing a death benefit nomination form. If you die after 75, your pension will be taxed as income (although no National Insurance payment will be due). In addition, your beneficiary might have to pay IHT if your pension pot is worth more than the applicable lifetime allowance for that tax year. Pension planning is a key area in which you should obtain advice from an independent financial adviser.

Contact

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