Friends Provident International

Inheritance tax planning problems and solutions

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Not for use with customers.

This guide will look at how an FPI trust could be used to reduce a potential UK inheritance tax liability for your client.

PROBLEM 1

Client A is a UK domicile who has been resident in the UAE for the past 5 years. They eventually plan to return to the UK to retire.

They have recently received a large inheritance payment. This payment will mean that their nil rate band (NRB) will be exhausted hence the need to look at inheritance tax (IHT) planning.

They would like to look for a way to invest this recent inheritance payment for their family's future without it affecting their IHT liability.

The client feels that they could afford to give up all access to the income and capital. The client is undecided on who should benefit from the investment, but has considered using the money for their children's future university education, or to help with a house purchase.

SOLUTION 1

FPI Gift Trust

As Client A feels that they are able to give up all access to the income and capital, using a Gift Trust would be a suitable solution.

The client decides to open an FPI policy with an initial investment of £200,000 and gifts this plan into a Gift Trust (discretionary version). The plan is now the Trust Fund.

Using the discretionary version of a trust allows additional flexibility as to who can benefit from the Trust Fund. For example: if they were to have future children.

To retain some control over when the Trust Fund benefits are paid and who these are paid to, they appoint themselves as one of the Trustees.

After 7 years the initial investment of £200,000 into the Gift Trust is outside of their estate for IHT. All growth of the Trust Fund is also outside of the their estate for IHT from day one.

The client as Settlor of the trust is unable to benefit from the Gift Trust. Therefore, the Gift Trust is only suitable as the client has confirmed that they do not require any access to the income or capital from the investment.

UK Tax mitigation: trust combined with an FPI policy

Income Tax – The trustees can control when and who any income tax liability will fall upon. For example: plan segments could be assigned to adult beneficiaries (lower rate tax payer) who would then be able to surrender the plan segments in their own name.

Capital Gains Tax (CGT) – Assets held within the policy are owned by FPI in the name of the life company. Therefore, no UK CGT charges arise on the owner of the plan when any assets are bought or sold.

IHT – The gift into the trust will be outside of the settlor's estate after 7 years. Any growth on the trust fund will be immediately outside of the estate.

PROBLEM 2

Client B is a UK domicile individual who has been resident in the Asia for the past 10 years. They eventually plan to return to the UK. The client's total wealth of £650,000 exceeds the current nil-rate band (NRB).

Potential IHT liability calculation:

£650,000 less £325,000 (NRB) = £325,000

£325,000 X 40% = **£130,000**

The client is concerned about their future standard of living or possible changes to their personal circumstance so is unable to make any outright gifts just now. They would like to find a way that could reduce any future IHT liability.

SOLUTION 2

FPI Loan Trust

Client B makes an interest free loan of £200,000 to the trustees. The trustees use the loan to invest into an FPI policy.

There is no transfer of value as the settlor has not made a gift (it is only a loan). Therefore, the £200,000 remains inside of the estate for IHT even after 7 years.

As the Settlor of the Trust, the client is able to recall the balance of the outstanding loan from the trustees at any time, but has decided that the trustees repay the loan at a rate of £10,000 a year (5% a year). The trustees will continue to make loan repayments until the loan has been fully repaid.

The settlor can cancel or increase the amount of the loan repayments that they are receiving. However, they should be mindful that they are only entitled to amount of the original loan.

Revised IHT liability calculation:

£650,000 less £200,000 (value of loan repaid to settlor and spent/gifted) = £450,000

£450,000 less £325,000 (NRB) = £125,000

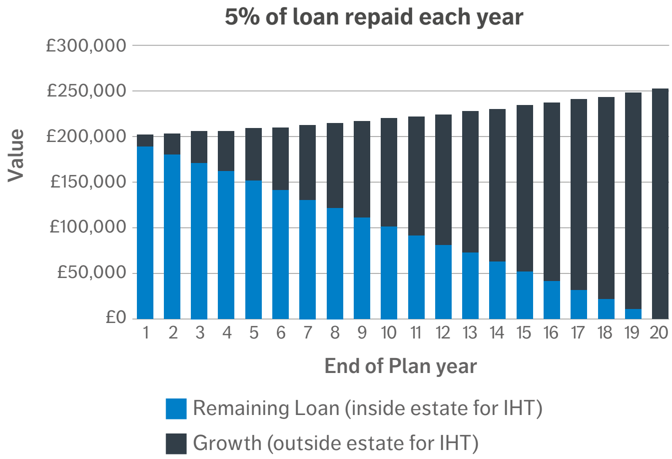
£125,000 x 40% = **£50,000**

The Loan Trust has reduced the potential IHT liability by **£80,000** (£200,000 x 40%)

Any investment growth is held for the benefit of the beneficiaries and is immediately outside of the estate.

NB: If the repayments are not spent or gifted they will form part of the taxable estate and negate some of the IHT benefit offered by the Loan Trust.

The following chart represents 5% of the loan (£10,000) being repaid for 20 years as well as the 'Growth' being outside of the client's estate.



UK Tax Mitigation: Trust combined with an FPI policy

Income Tax – The trustees can control when and who any income tax liability will fall upon. For example: policy segments could be assigned to adult beneficiaries (who is a lower rate tax payer) who would then be able to surrender the policy segments in their own name.

Capital Gains Tax (CGT) – Assets held with the policy are held in the name of the life company. Therefore, no CGT charges arise on the owner when any assets are bought or sold.

IHT – There is no transfer of value when setting up this trust. The loan to the trustee remains inside of the estate of the settlor even after the 7 year period.

The IHT benefit works as the value of the capital that is used to fund the loan trust is frozen in the estate. All growth of the trust fund is for the benefit of the beneficiaries and is outside of the estate from day one.

If the settlor is not spending/gifting the loan repayments they will form part of the settlor's estate.

PROBLEM 3

Client C is age 64 and having worked most of their life in the Middle East is planning to return to the UK. Their current wealth is £1,000,000 which exceeds the available nil rate band (NRB).

If the client were to die today the potential IHT liability would be calculated as follows:

£1,000,000 less £325,000 (NRB) = £675,000
£675,000 X 40% = **£270,000**

The client would like to make a gift to immediately reduce their IHT liability, but at the same time still requires a regular income from the capital to fund their retirement.

SOLUTION 3

Discounted Gift Trust (DGT)

This solution requires the client to complete a health questionnaire and pass medical underwriting.

Client C makes an investment of £450,000 into an FPI policy that is assigned into a DGT.

The client decides to carve out an income of £22,500 (£450,000 x 5%) from the trust fund. The income is payable on a monthly basis for the rest of their lifetime (or until such time as the trust fund expires).

Based on the client's age, level of withdrawals, and state of health the value of the withdrawals are valued at £320,850 (this is known as the Discount) after medical underwriting.

This results in the transfer (the gift) into the trust being discounted to £129,150 (£450,000 less £320,850). If the client were to die within 7 years there would be an immediate IHT saving of:

£1,000,000 less £320,850 = £679,150 (new estate value)
£679,150 less £325,000 = £354,150
£354,150 x 40% = **£141,660**

After 7 years the remaining £129,150 (the gift) would also be outside of the client's estate for IHT. Any investment growth is immediately outside of the estate from day one.

The client is unable to cancel or vary the income payments. Therefore, any income payments that they receive must be spent or gifted.

NB: Unlike the Loan Trust. There is no restriction on the number of payments that can be made to the settlor. The payments will continue until the settlor dies or the trust is depleted.

UK tax mitigation when trust combined with an FPI policy

Income Tax – The trustees can control when and who any income tax liability will fall upon. For example: policy segments could be assigned to adult beneficiaries (who is a lower rate tax payer) who would then be able to surrender the policy segments in their own name.

Capital Gains Tax (CGT) – Assets held with the plan are owned by FPI. Therefore, no UK CGT charges arise on the plan owner when any assets are bought or sold.

IHT – The DGT allows the investor to make an immediate gift for IHT purposes but retain a regular income. The transfer of value for IHT purposes is less than the value of the investment. This allows an immediate IHT saving should the donor die within the first 7 years.

After 7 years the whole gift is outside of the estate for IHT purposes. It is important that the income payments are spent otherwise they will form part of the estate.

Important notes

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The tax treatments and information contained in this document are based on our understanding of current tax law and HMRC practice as at July 2021 and may be subject to change in the future.

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FPITECH011a 08/21