

Trusts and Life Assurance: Complementary Vehicles in a 21st Century World

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Practitioners are increasingly acknowledging the wisdom of combining two of the most effective wealth planning methods available today: trusts and life assurance.

While similar in many respects, both vehicles do offer distinctive characteristics which when properly amalgamated can result in a particularly powerful client tool in the hands of a skilled professional.

Overview

The topic of trusts (including non-UK trusts) is more than adequately covered elsewhere. The focus of this summary will be on life assurance in a trust setting with a sub-emphasis on the trust application of utilizing life assurance issued by life offices which do not carry on such a trade within the UK (henceforth “offshore life assurance”).

Of the 194 sovereign and sixty-five non-sovereign jurisdictions in the world today, the laws of 158 of the former and thirteen of the latter provide varying degrees of merit with respect to the life assurance vehicle. Commonly-cited advantages of life assurance include its general public acceptance, universal legal recognition, contract portability, contract confidentiality, and often favorable local laws in connection with taxation, asset protection, and forced heirship.

UK Life Assurance Law

In the UK, there is no entirely satisfactory statutory definition of life assurance although

the courts on occasion have attempted to come up with just such an explication.¹ Life assurance is a unique form of intangible personal property. Being contractual in nature, a life assurance policy is neither an “account” nor an “entity” in the usual sense; it is a chose in action. The nature of a policyholder’s ownership interest lies not in the legal nor equitable title to any asset or assets backing an applicable policy but rather as only a *contractual claim* in an unsecured manner against the carrier in question. This can be very significant internationally in an ever-increasing world of “transparency”. Moreover, the contractual nature of a life assurance policy may supply a policyholder with relatively wide latitude in the choice of proper law with regard to a given contract. This is important, for instance, in that some non-UK jurisdictions might provide a more liberal standard in the realm of insurable interest—particularly in the case of trustees possessing such an interest in the life of the settlor or in the life of a trust beneficiary.²

A life assurance policy need have little or no mortality risk in order to be classified as such for purposes of UK law. Nonetheless, in a domestic context, the actuarial design of a policy will have a strong bearing on its particular tax characteristics.

UK Life Assurance Taxation

Historically, the most-touted tax advantages associated with life assurance are the possibilities of (1) tax-free growth of the “inside buildup”, (2) tax-free distributions prior to the death of the insured(s), and (3) tax-free death benefits. In the UK, only certain policies issued by certain carriers entitle an individual policyholder to all of these tax benefits. Specifically, UK legislation distinguishes between *qualifying* and *nonqualifying* policies.³ For the most part, since 17 November 1983, only life assurance policies issued by UK carriers (or others lawfully carrying on a UK life assurance business and where applicable premiums are payable to a branch in the UK and such premiums form part of the business receipts of that branch)⁴ can be put in the former group-

¹ See, eg, *Gould v Curtis* [1913] 3 KB 84.

² Cf Life Assurance Act 1774 §§1 and 3.

³ See generally Income Tax (Trading and Other Income) Act 2005, Part 4, Chapter 9.

⁴ See Income and Corporation Taxes Act 1988 Schedule 15 ¶24(3).

ing.⁵ All other policies must be put into the latter grouping.

Nonqualified policies subject a UK resident policyholder⁶ to UK income tax liability upon the occurrence of a “chargeable event”.⁷ This category includes but is not limited to (1) a death giving rise to benefits under a policy, (2) the maturity of a policy, (3) a complete surrender of a policy, (4) an assignment of an entire policy for consideration, and (5) a “calculation event”⁸ such as a partial surrender, etc, resulting in proceeds in excess of defined amounts being received by a policyholder.

Although a capital asset under UK law, unless acquired for actual consideration, life assurance policies are not chargeable assets for UK capital gains tax purposes.⁹

There is currently no premium tax on life assurance policies in the UK—whether of the qualified or nonqualified variety.

There is no UK stamp duty with respect to life assurance policies generally (including most assignments) as well as with trusts of life assurance policies.

In the UK, since life assurance is categorized as a non-income-producing asset, unless and until a chargeable event occurs, there generally is nothing for a UK individual to report on his or her self-assessment form to HMRC.

Offshore Life Assurance For UK Individuals

There are no UK restrictions on a UK resident purchasing an offshore life assurance policy. There are, however, tax and regulatory restrictions on non-UK carriers that are not authorized to conduct an assurance business in the UK from soliciting such business from within the UK. Because of this, it is advisable at the very least that putative purchasers execute any proposal, etc, outside of the UK. For this and other reasons, often the applicant and initial owner of an offshore life assurance pol-

icy is a non-UK trust established primarily for the benefit of the family of a UK settlor.

In many respects under UK law, there is no distinction between a UK life assurance policy and an offshore life assurance policy. However, there may be some advantages associated with an offshore contract. In general, for example, there is far more flexibility regarding currency denominational choices with offshore life assurance policies than there is with UK policies. Also, UK law generally restricts UK carriers from placing policy assets outside of the UK.¹⁰ There are also restrictions generally with respect to the nature of investments which can be made by a UK carrier.¹¹ Offshore carriers do not typically have these restrictions.

An offshore life assurance policy by itself will not normally attract any UK tax liability since such a policy is not a UK-based investment. This includes UK capital gains tax liability when policy fund switches occur. However, the underlying assets of a given policy—if they are located within the UK—may be subject to UK withholding taxes at the entity level since it is unlikely that the home jurisdiction of an offshore carrier is a party to a double taxation treaty with the UK.

As mentioned, since all offshore life assurance policies are—by definition—nonqualified under UK law, they do not offer all of the tax advantages normally associated with life assurance. Even so, a benefit that they do offer UK residents is the opportunity of tax deferral (“rollup”) regarding any gain within this type of policy.¹²

As previously noted, a nonqualified policy does not inherently provide a tax-free death benefit in favor of a UK resident.¹³ Nevertheless, the

⁵ As alluded to earlier, there are also technical restrictions regarding the actuarial design of qualifying policies, *eg*, a required minimum term and minimum percentage of mortality cover in excess of the surrender value for certain contracts.

⁶ UK nondomiciliaries who are resident are given no special privilege: the remittance basis does not apply.

⁷ See Income Tax (Trading and Other Income) Act 2005 §§462 and 484.

⁸ See Income Tax (Trading and Other Income) Act 2005 §§498 to 514, *inclusive*.

⁹ See generally Taxation of Chargeable Gains Act 1992 §210.

¹⁰ See Insurance Companies Act 1982 §35(1).

¹¹ See Insurance Companies Act 1982 §38.

¹² Perhaps the most common type of policy issued by offshore carriers to UK residents is a “bond”—a so-called *offshore bond*. These instruments are considered life assurance policies—albeit once again nonqualified under UK law—because they are issued by life assurance carriers and they possess a (usually nominal) level of mortality cover in excess of the surrender value. Aside from the aforementioned rollup, a much-publicized advantage of this sort of product is the general ability of a policyholder to encash up to 5% of such a policy’s principal per annum for up to twenty years without tax consequence. Technically, this feature is merely a return of capital to the policyholder. See Income Tax (Trading and Other Income) Act 2005 §492(1)(b) and Income and Corporation Taxes Act 1988 §546.

¹³ See Income and Corporation Taxes Act 1988 §§540 and 541.

measure of gain (“investment profit”) in a taxable situation is the difference between a policyholder’s base cost (*ie*, premiums paid) and the its surrender value immediately prior to the insured’s death—not the total death benefit.

A special type of life assurance policy—known in the UK as a personal portfolio bond (“PPB”)—permits a policyholder to have a great deal of control over the selection of the assets comprising a policy’s underlying fund.¹⁴ For UK residents, PPBs are taxed in a draconian manner in which applicable taxation is cumulated to the inception of the policy.¹⁵ Keep in mind that PPB characterization cannot arise unless a policyholder has via the arrangement the direct power (or “imputed” power in certain circumstances) to select the assets comprising the underlying fund. A somewhat open issue is whether or not the mere selection (and subsequent appointment) of an investment adviser is sufficient by itself to expose oneself to the PPB net; it appears that, in the view of HMRC, if the adviser is effectively acting as the applicable policyholder’s mere agent or conduit, a negative result can be expected by that policyholder. On the other hand, situations involving truly independently-managed funds (particularly in connection with “preexisting” managers and brokers) should pose no difficulty for the policyholder.

Life Assurance Trusts For UK Individuals

Due to a continuing attack upon the use of non-UK trusts settled by UK individuals—at least from a tax perspective—many financial advisers are now suggesting that their affluent clientele consider marrying policies of life assurance—particularly of the offshore variety—with such trusts to ameliorate any applicable UK taxation.

Indeed, arguably the best way for a UK taxpayer to hold a life assurance policy is vis-à-vis the trust vehicle. Largely, this is because life assurance policies which are owned by UK individuals are grabbed by the UK inheritance tax net. To be precise, for individuals who are either domiciled or deemed domiciled¹⁶ in the

UK, ownership of life assurance (whether of the UK or offshore variety) will potentially result in UK inheritance tax liability. However, this result can be avoided by having such policies owned by a suitable (domestic or offshore) life assurance trust,¹⁷ funded in a timely manner.¹⁸ As with the use of any trust, tax ramifications impacting the settlor must be considered but if essentially the sole asset of the trust is a well-designed life assurance policy, those concerns can be largely alleviated.

With respect to UK income taxation resulting from the holding of nonqualified life assurance policies, trusts are subject to such tax regardless of their individual status as UK residents. However, since once again life assurance is a non-income-producing asset, a trustee’s income tax return can be greatly simplified in the absence of a chargeable event. Also as previously noted, in the UK, a life assurance policy is outside of the scope of the capital gains tax and thus the trustee of a life assurance trust need not be particularly concerned with the trustee annual CGT exemption nor with the complexities of taper relief for nondomiciliaries.

While specific trust drafting issues are beyond the scope of this summary, one concern that should be addressed is whether the applicable trustee has the requisite authority to invest its trust funds in one or more life assurance policies. Since the passage in the UK of the Trustee Act 2000, the answer should be in the affirmative. Another potential issue can arise in the event a trust corpus is solely or primarily composed of life assurance policies and there exists a life tenant with definable rights under the trust. No matter, capital payments to a trust beneficiary should not ordinarily present a problem taxwise insofar as a trustee is not required to augment income out of trust capital in the context of a discretionary trust.¹⁹

US Supplement

The United States is one of the very few countries in the world that taxes its citizens irrespective of their domicile or residence. In the

¹⁴ The resulting PPB legislation in the UK was a reaction to the famous tax case of *IRC v. Willoughby* ([1997] STC 995). The late Professor Willoughby served as an important mentor to the author of this summary.

¹⁵ See Income Tax (Trading and Other Income) Act 2005 §§515 to 526, *inclusive*.

¹⁶ See generally Inheritance Tax Act 1984 §267.

¹⁷ *Cf* Inheritance Tax Act 1984 §3A.

¹⁸ Under UK law, generally transfers (including the funding of most trusts) made by a donor within seven years of his or her death are not excludible for inheritance tax purposes. See Inheritance Tax Act 1984 §7.

¹⁹ See generally *Stevenson (Inspector of Taxes) v Wishart* [1987] STC 266.

case of individuals, the general extent of this wide-reaching taxation applies with respect to, *inter alia*, federal income and capital gains taxation and federal gift taxation, federal estate taxation, and federal generation-skipping transfer taxation. In general, this tax net applies to all individuals holding a US passport (regardless of any others held)—including “permanent” expats in the UK and elsewhere.

Although otherwise permissible under the 16th Amendment to the US Constitution, the federal legislature in the US has opted to award life assurance preferential tax treatment ever since the adoption of its modern-day income tax commencing on 1 March 1913.²⁰

Like the UK, the US imposes no restriction on its citizens (resident or otherwise) from holding (directly or indirectly) an offshore life assurance policy. Similarly, the US categorizes life assurance policies as either qualified or nonqualified. Qualified policies satisfy certain actuarial and other requirements in order for policyholders to enjoy tax benefits comparable to those afforded UK individuals who own qualified policies under the laws of their jurisdiction.²¹ Nonqualified policies do not offer the same tax advantages. However, one major distinction between the two jurisdictions’ laws is that, in the US, it is not necessary that a qualified policy be issued by a domestic carrier nor one doing a life assurance business in the US; in other words, as long as an offshore carrier designs a policy which meets the specifications called for under US tax law, such a policy should be able to provide the same tax consequences to the policyholder as one issued by a domestic carrier.²²

US law, like that in the UK, provides differing tax treatment generally between that of domestic trusts and trusts settled elsewhere. The law in the US permits ownership of either domestic or offshore life assurance policies by either US or non-US trusts. Most important to practitioners, the tax (rather than reporting) consequences can be almost identical between these various scenarios. Principally, this is because under US law life assurance policies

are also categorized as non-income-producing assets.

Interesting planning possibilities can present themselves with respect to US individuals who own offshore life assurance policies.²³ Significantly, the death benefit of even a nonqualified life assurance policy under US tax law should in most cases be entitled to full income tax-free treatment with respect to the death benefit.²⁴

A Word About Asset Protection

The combining of trusts and life assurance can be especially compelling in connection with asset protection planning. In some cases, it can offer a kind of “triple protection”. First, there is the use of any applicable trust law (local or otherwise) pertaining to asset protection issues. Second, there is the possible exploitation of specific statutory protections under the proper law of the applicable contract peculiar to life assurance policies. Finally, there may exist specific statutory or other asset protection relief in favor of life assurance provided under the domiciliary or residency law of any affected policyholder or beneficiary.

Professor Hampton is the chairman of a major annual life assurance and annuities conference in London that normally takes place in September. The host sponsor of the conference is Informa/IBC Global Conferences. Academic and special counsel to selected international institutions and domestic firms for more than thirty years, he has also acted as both an expert consultant and expert witness in regard to various legal matters.

DISCLAIMER

Please be advised that this summary is made available only as a general educational aid in understanding the subject matter covered and it should not be relied upon as a specific guide for individual use. All of the information provided herein is subject to revision and clarification.

²⁰ See generally Internal Revenue Code §101 and its predecessor statutes.

²¹ See generally Internal Revenue Code §§72, 817, 7702, and 7702A.

²² Depending on the facts involved in a given situation, one possible distinction is the imposition of a federal excise tax on premium payments in the case of a policy issued by an offshore carrier. See Internal Revenue Code §§4371 *et seq.*

²³ See generally Hampton, “International Life Insurance Presents Unique Planning Opportunities”, Vol. 24 (No. 4) *Tax Management (BNA) Estates, Gifts and Trusts Journal* 175 (July-August 1999).

²⁴ However, special care and policy selection will be necessary in the case of life assurance policies owned by *offshore trusts* in order to achieve this favorable result.