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Protect your life insurance payout from Inheritance Tax

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An increasing number of estates are falling within the Inheritance Tax net each year, largely due to rising property prices and frozen tax thresholds. The Office for Budget Responsibility forecasts that HM Revenue & Customs (HMRC) will collect £8.7 billion in Inheritance Tax for the 2025/26 tax year^[1].

If you have a life insurance policy, it is important to ensure it falls outside your estate by writing it into an appropriate trust. This means it will not count towards the value of your estate when calculating how much Inheritance Tax (IHT) you may owe.

Here, we look at how life insurance is often used to cover potential IHT bills and how to protect any payout from being included in your estate for Inheritance Tax purposes.

SECURING FINANCIAL PEACE OF MIND

Most people take out life insurance to ensure their loved ones are financially protected if they die. It provides valuable peace of mind that financial commitments, such as a mortgage, will be covered. It also helps manage other expenses that could otherwise go unpaid if you are no longer around.

Increasingly, people are using life insurance to provide their loved ones with a lump sum to cover any Inheritance Tax bill upon their death. Although this will not reduce the amount you have to pay, it means your family will not end up with a potentially large bill to pay directly from your estate.

IMPORTANCE OF TRUST ARRANGEMENTS

If you do not write a life insurance policy into an appropriate trust, the proceeds on your death will simply increase the value of the money and property you leave behind. Life insurance can be a very effective estate-planning tool, but only when

structured correctly to keep the payout separate from your taxable estate.

Using a trust can also save up to 40% in Inheritance Tax on the payout, and means you do not have to wait for probate. Probate can take many months, tying up essential funds. If not held in trust, the policy may be taxed for IHT and delayed, defeating its very purpose of providing quick liquidity to cover taxes and day-to-day bills.

TAKING PRACTICAL STEPS TO PROTECT YOUR WEALTH

Putting your life insurance policies into an appropriate trust is straightforward. You can do this either when you take out cover or later. We can assist you with this. If you have life insurance that is not currently in trust, please contact us and we'll explain what to do next.

Provided you are in good health when you place the policy in trust, there are normally no Inheritance Tax implications, as the policy has no value. However, if you are seriously ill when you place the policy in trust and die within seven years, HMRC may consider the policy to have had value at the time of transfer and may seek to charge Inheritance Tax. If you are a couple, consult us to ensure you minimise the Inheritance Tax bill when the second person dies. ■

Source data:

[1] <https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/inheritance-tax/>

HAVE YOU SECURED YOUR WEALTH FOR YOUR FAMILY'S FUTURE?

If you are unsure whether this is the right option for you or need help navigating the complexities of trusts and Inheritance Tax, please contact us to safeguard your family's wealth.

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