Life insurance trusts - benefits explained for contractors

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Contractors who don't create a life insurance trust when taking out a life insurance policy could leave their dependents with a hefty and unnecessary inheritance tax (IHT) bill if the policy pays out as a result of the contractor's untimely death.

"If a contractor has a life insurance policy and no trust, any payout is added to the contractor's estate," explains Mark McBurney, life and income protection expert at Contractor Financials.

"This could mean both long delays before the contractor's loved ones receive a life insurance payout and, depending on how a contractor's will is structured, what could amount to a significant IHT charge on the insured sum."

What is a life insurance trust?

According to McBurney, a life insurance trust 'ring fences' the cash paid out by a life insurance policy so that it is paid into a trust and not into the contractor's estate. The contractor decides who the trust's beneficiaries will be, typically their dependents.

Trusts are simply one way that a contractor, the 'settlor', can manage assets they might want to pass on to their family, the 'beneficiary'. There are many reasons why trusts are created. These can include controlling family assets, taking care of assets for a child or someone too young to manage their own affairs, or passing on assets on death.

"Life insurance trusts are very straightforward and most if not all life insurance providers offer them on their policies," continues McBurney. "A unique trust is created for each life insurance policy, so there is not much more for the contractor to do than complete some paperwork and there is little or no additional cost."

What happens if there is no life insurance trust?

McBurney believes that creating a life insurance trust basically allows a life insurance policy to do what it should do: "Most people assume they take out life insurance and if they die, their loved ones quickly receive a payout that ensures their financial stability.

"But this is not what happens to a policy if there is no trust. Without a trust, the payout is added to the contractor's estate. This means that the insured sum paid out is subject to IHT. For most contractors, who have sizeable estates on death, this means a significant tax bill.

"Perhaps what is more distressing for the family is that because the payout is added to the estate, it only gets paid out when the estate is settled. The family could be waiting months for probate to complete. During this time, there will be expenses to pay and, if the contractor's spouse or partner does not work, household expenses to cover."

What are the benefits of a life insurance trust?

By creating a life insurance trust, any life insurance payout goes directly to the contractor's beneficiaries tax-free and not into the contractor's estate. The family receives the full insured sum quickly, meaning any money worries should be taken care of.

In McBurney's experience, quite often having a life insurance trust can mean keeping a roof over the family's head: "If the mortgage and house is in the contractor's name, on their death most lenders will take steps to repossess and sell the property. If they take possession, the widow/widower or surviving partner can buy back the house if they have the proceeds of the life insurance."

And in addition to a fast payout, the trust ensures that the taxman does not take a large slice of the payout. Inheritance tax (IHT) is currently charged at 40% on sums above £325,000 (correct at the time of writing), which could cut a huge amount from any payout.

How to create a life insurance trust

Normally, when creating a trust that has a variety of financial and property assets for the purposes, for example, of creating an income for children, then a solicitor would be involved and professional fees would be incurred.

"Life insurance trusts are not that complicated and are a standard part of our processes when arranging life cover," says McBurney. "The provider knows that the trust will be created only for that policy and not for complex assets and properties, and the structure has been signed-off by their risk managers.

"The process is literally as simple as completing a form that includes some legal jargon and specify who should benefit."

Contractors who have existing life insurance policies that have not been written into trust can update the policy, but a solicitor may have to be involved that could incur additional fees. But the resulting tax savings, and peace of mind, would be worth it for many.

McBurney concludes: “There are a surprising amount of financial advisers who don’t know about life insurance trusts and don’t automatically create one for every life insurance policy.

Mark McBurney

Protection Team Manager

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Mark McBurney is an experienced financial adviser, with ten years' history in the mortgage market, now specialising in protection for contractors.

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“Contractors should ensure that any new life insurance policies are written into trust. Those with existing policies should review their cover and, if necessary, update their policy or take out a new one to benefit from a life insurance trust.”

Published: Thursday, August 13, 2015