Using the Rysaffe principle for inheritance tax planning

A future inheritance tax (IHT) bill and funeral expenses can be met by writing a whole of life policy in trust. However, as shown below, it can sometimes be advantageous to write a series of smaller policies, each subject to its own trust, using the Rysaffe principle.

What is the Rysaffe principle?

The Rysaffe principle dates back to 2003 and the case of Rysaffe Trustee Co (CI) v Inland Revenue Commissioners. In this, the court ruled that where a series of trusts are created by the same settlor, they will not be regarded as related settlements for IHT purposes, provided they are created on different days.

Where this is the case, each trust benefits from its own nil rate band. This is significant because a trust is assessed every 10 years and if its value exceeds the nil rate band – currently £325,000 – the excess will be subject to a periodic charge (a maximum rate of 6%). A charge is made even more likely when you consider that it's also necessary to include any chargeable lifetime transfers (CLTs) that the settlor made in the seven years prior to the trust being settled.

By using the Rysaffe principle to create a series of smaller trusts and thereby benefitting from multiple nil rate bands, it reduces the risk of periodic charges, as well as exit charges when capital later leaves the trust.

The Treasury has explored ways to challenge the principle. In 2013, it considered introducing a single settlement nil rate band, which would be divided across all of a settlor's trusts. Instead, it opted for an anti-avoidance 'same-day added property rule', which came into effect in 2014. While this means the Rysaffe principle is no longer effective for multiple pilot trusts set-up with a nominal value, it remains a valid planning tool for life assurance protection plans.

Planning opportunities

As we know, putting a whole of life policy in trust helps to avoid delays in the payment of benefits and ensures that those benefits fall outside of the deceased's estate for IHT purposes.

Under relevant property trust rules, the value of the trust will be assessed at every 10-year anniversary to determine whether it is subject to a periodic charge. For a whole of life policy, the value during the settlor's lifetime will be the greater of the market value of the policy and the total of all premiums paid to date. The market value could be the surrender value (if applicable) or if the life assured is seriously ill, what the policy would be worth on the open market.

Where cumulative premiums are anticipated to be greater than the nil rate band over the policy's lifetime, using the Rysaffe principle can be beneficial. Spreading the sum assured across a series of policies taken out on different days will reduce the risk of periodic and exit charges being levied.

Example

Roger is 71 years old and wants to take out a whole of life policy for a sum assured of £5m to ensure the funds are available to pay for his funeral and cover the IHT liability on his estate. Roger has made no previous CLTs and for the purposes of this example, we'll assume the nil rate band will remain at £325,000 throughout and all premiums fall within an exemption, such as normal expenditure.

Taking out one policy

If he takes out a single policy for £5m, the annual premium would be £45,000. At the first 10-year anniversary, he would have paid £450,000 in premiums. This is £125,000 over the nil rate band and is therefore subject to a periodic charge of £7,500 (6%).

At the second 10-year anniversary, the premiums would total £900,000. This is £575,000 above the nil rate band and therefore liable to a periodic charge of £34,500.

Using the Rysaffe principle

Instead, Roger takes out five £1m policies, placing them in five separate trust arrangements over the course of five days.

Therefore, at the first 10-year anniversary, he would have paid premiums of £90,000 on each trust and there would be no periodic charge. At the second 10-year anniversary, the total premium on each policy would be £180,000, still carrying no periodic charge liability.

It would take until the fourth 10-year anniversary – when £360,000 of premiums would have been paid on each policy, incurring five periodic charges of £2,100 (£10,500 in total) – before these trusts triggered any periodic charges. But, as Roger would need to live to age 111, he might consider it a risk worth taking.

Note: The Rysaffe principle was not under review by HMRC at the time of publication but may be in the future. All figures and tax bands used in this article were correct at time of publication.

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