An Introduction to Financial Protection for the R05 exam

About the exam and this guide

The R05 exam is a one hour exam consisting of 50 multiple choice questions. It is tested to the current syllabus as set out by the CII. This is split into different Learning Outcomes and the syllabus will tell you the approximately how many questions you can expect to get on each one. Each Learning Outcome is split into different "indicative contents" which list in more detail what will be tested. You should note that whenever a question is assessed as being suitable to go into a test paper the first check is whether it is testing an indicative content. If it does not then it cannot be included.

This guide is not intended to replace the CII study manual but rather to complement it. It can also be used as an introductory guide as quite deliberately it does not go into the same amount of detail but focuses on the key points you must know to pass the exam and also help you build a platform for further study.

Insurance or Assurance

If you want to be really accurate insurance refers to protection against something that might happen. Car insurance protects you against your car being damaged.

Assurance protects you against something that will happen. As death will always happens it is more accurate to refer to Life Assurance. However the terms are interchangeable and in the text both will be used.

The need for protection

If asked to name their most important asset most people would probably reply that it was their house. Some might say it was their pension but in fact the most important asset we have is our ability to earn an income.

Short of winning the lottery or marrying a millionaire most of us have to work. This brings in money that pays for all the things we need. This ability to work and to earn can be stopped by:

- Death
- Illness and/or disability

Financial protection products are designed to mitigate the financial consequences of these events.

Whilst everyone is at risk of these events, and of course we all will die, the financial consequences will vary from person to person.

Helen is 24, is employed and is single with no dependents. She currently rents.

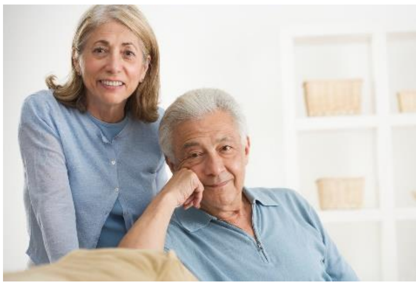
If she had died yesterday no one would suffer financially so at this stage she doesn't have any need for life insurance.

If she became ill or suffered a serious accident her employer would pay her for, say, six months but after that she would start to suffer significant problems. How could she pay her rent? She should therefore consider some form of protection against long term illness or disability.

The Browns have a young daughter. Since her birth Mrs Brown works on a part time basis and they mainly rely on Mr Brown's income. They also have a mortgage which has 20 years to run.

Death of either parent would have significant financial effects. How could the mortgage be paid? How would they pay for all the outgoings? If Mrs Brown were to die would Mr Brown be able to afford childcare?

These problems would also occur if either were to suffer serious illness or disability



The Smiths are in their late 60's and both are retired. They each have good pensions and live in a mortgage free house.

Their pensions will be paid until they die so the death of one should not financially impact on the other. Whilst it's quite likely that one or both will suffer a serious illness their pensions will continue to be paid

So on the face of it neither requires any form of protection. There is however one area they might want to consider and that is the impact of Inheritance Tax.

Giving advice on financial protection should always start with ascertaining whether anyone would suffer financially if that person were to die or suffer a serious illness.

For someone of working age it is almost always the case that there will be financial consequences if they cannot work due to accident or sickness. With death the situation is not always as clear and it may well be the case as we saw with Helen that there are no consequences.

Good protection advice generally means putting the individual, or their surviving dependents in the case of early death, in roughly the same financial situation pre death/ill health. This will require a more detailed analysis which should normally include the following:

Death

- What debts does the individual have?
- What income will the survivors need to meet their outgoings?
- What existing policies do they have?
- What death benefits, if any, would they get from their employer?

Illness/disability

- How long would the employer pay you sick pay?
- If you are self-employed how long could you manage without your income being affected?
- How long would this replacement income needed to be paid for?

How insurance can solve this problem

The one certainty in life is that we will all die. What none of us know is when it's going to happen. Ordinary observation tells us that we have a reasonable expectancy of living into our late 70's or mid 80's.

Unfortunately some will die prematurely A 25 year old will think quite correctly that he is likely to survive until 50 but cannot be sure that that will be the case. Put another way there is a low probability that he will die but the financial impact if it were to happen would be severe. What he can do is to transfer this risk to an insurance company.

Insurers can do this as birth and death records have been collated since 1837, they can use this data to calculate the probability of an individual reaching a certain age. In simple terms an actuary, the person who calculates this probability, would say that given a group of 1,000 25 year olds, the normal expectation would be that between 20 and 25 would not reach 50. Based on this information an insurance company can offer a policy that in return for a known fixed cost, the premium, an individual's dependents can receive a substantial sum in the event of not surviving until 50. This is called **mortality risk.**

Obviously not everyone in this pool will have the same level of risk, or put another way, some are far more likely to die before they reach 50. Insurers will have **standard rates** for a person of a given age but will want to identify those who are a higher risk as they may wish to exclude them completely or charge then more than standard rates. This will be looked at in a later section but at this stage the most common additional risk factors are likely to be obesity and adverse health considerations.

A similar process occurs in insuring against illness and disability. This is called **morbidity risk.**

The next section will look at individual life policies.

Life Policies

Let's start with the most obvious point:

All life policies pay out benefits when a named person dies.

In that respect a life policy is a fairly simple concept, after all there can be (usually) no dispute whether a person is alive or dead!

The key points of all life policies are as follows:

- A life policy is a contract between an insurance company and a policy holder
- The policyholder agrees to pay the premiums and the insurer promises to pay out the agreed sum assured if a named person, the life assured dies.
- The policy holder and the life assured can be the same or they can be different.
- A policy can have two assured lives. Payment is usually made on first death. This is a **joint life first death policy.**
- A life policy that runs for a set period is called a **term** policy.
- A life policy that has no term is called a **whole of life** policy

Policy holder and life assured

Before moving on this important point should be covered.

- The policy holder (and sometimes referred to as the planholder) is the person taking out the policy.
- As stated above this person can insure their own life in which case it is issued on an **own life** basis.
- The policyholder can also insure another person's life when it is referred to as **life of another**.
- However this is not an absolute right and you cannot insure anyone you choose.
- There must be **insurable interest** between the two when the policy is taken out.
- Insurable interest exists between spouses and civil partners. Otherwise it must be shown that the death of the life assured would result in a financial loss to the policy holder. Today there is usually no problem in co-habiting couples in insuring each other. You could also insure the life of someone who owed you money but only to the extent of the size of the debt. You should note that there is no insurable interest between children and parents or vice versa.
- If insurable interest does not exist then the policy is null and void. In other words if the life insured dies the policyholder cannot make a valid claim.
- However it only needs to exist when the plan is taken out. For example if Mrs Smith insures her husband's life and they then divorce, the policy is still valid. If Mrs Smith keeps paying the premiums she can still claim if her ex-husband dies

Term Policies

- A term policy lasts for a fixed term, say 20 years, and only pays out if the life assured dies within that term. If they survive nothing is payable
- It offers pure protection and if the policy is cancelled nothing is payable.

As such a term policy matches the needs of many people as their greatest exposure to the financial consequences of early death is between the 20's and 50's when they are raising a family and paying off a mortgage. Once the children become independent and the mortgage is paid off then the need for life protection is reduced.

In addition as most 25 year olds will survive another 20 or 30 years the cost of this cover is fairly inexpensive.

Term policies can be

- Level term
- Increasing Term
- Decreasing Term
- Convertible Term

<u>Level Term</u>

As the name implies the sum assured remains the same throughout the term

<u>Increasing Term</u>

The sum assured increases, usually on an annual basis but the premium stays the same. This is more expensive that level term

<u>Decreasing Term</u>

The sum assured reduces but the premium stays level. The two main types are:

- Mortgage Protection Policies
- Family Income Benefit Policies

A Mortgage Protection Policy decreases in line with the outstanding loan on a repayment mortgage

A family income policy (FIB) pays the benefit as a regular income. This is usually expressed as a monthly amount. This is paid from date of death to the end of the policy. It is decreasing because the liability of the insurer decreases as time goes on. It can usually be arranged that the amount of monthly cover will increase year by year and normally in this situation the premium also increases.

Convertible Term

This allows a term policy to be converted or changed into another policy without any underwriting. This is normally referred to as “without evidence of health”.

Traditionally they were able to be converted into an investment type policy after five years.

In addition the conversion option may allow the planholder to increase the sum assured and/or the term at set points. This is usually available with mortgage protection policies so that a new plan can be taken out when a new mortgage is arranged

Whole of life policies

- These have no term and will pay out whenever death occurs
- They are therefore more expensive than term policies
- If cancelled (policy surrendered) some money may be paid but this will be very low in the early years.

As with term policies they come in a variety of different forms.

Non Profit WOL

This is the simplest type as the sum assured is fixed and never changes throughout the whole term. It's fairly rare to find this type now but they are used for funeral plans. Since none of us knows when we are going to die, a term policy would not be suitable

With profit WOL

This introduces an element of investment. There is a guaranteed sum assured or death benefit and the company can increase this each year by paying an annual bonus. There is no guarantee that this will be made but once it is declared (using the insurer's jargon) it cannot be removed. They can be useful method of paying a future IHT liability. Whilst it may be possible to predict how much tax would be payable today, this may be higher in 20 years' time so a with profit policy gives some protection against this increasing liability. This type of plan will usually give a higher surrender value than a non-profit policy.

Unit Linked WOL

With this type of policy the distinction between protection and investment becomes blurred.

At one extreme there is the **Insurance Bond**. This is a single premium policy where the initial investment is placed into funds of the client's choice. There is a minimum amount of life cover, usually 1% of the fund value so there is no underwriting. It is primarily an investment product.

Another option is sometimes referred to as the **universal whole of life plan**. The theory behind this plan is that it can be altered to meet the changing balance of protection and investment throughout the plan.

- It is a regular payment plan.
- There is a guaranteed death benefit.
- Unlike a regular WOL plan where the premiums and dearth benefit are fixed, with this plan the premiums are used first to buy units in different funds, some of which are then cashed in to pay for that month's life cover.

- If the client goes for maximum life cover it is unlikely that the fund will grow since most of it is being used to pay for life cover.
- On the other hand if it is used to get maximum investment, the death benefit will be lower but the fund will grow in value more. Alternatively if a higher premium is paid the higher death benefit can be paid.
- As it is unit linked the policyholder can surrender the policy and get back the current value of the units.

These plans have fallen out of favour as they have a number of significant drawbacks.

- The charges were very high in the first few years which meant that little if any money was being invested.
- The level of death benefit was only guaranteed for 10 years and if maximum life cover had been selected the client usually had to increase this to keep the same level of life cover.
- These reviews would then be carried out every five years with the same possibility that the life cover would have to be reduced or the premium increased.

Endowment Policies

Although these aren’t really protection policies it is worth noting the main details:

- Like term policies they run for a set period.
- The sum assured is paid out on death but also at the end of the policy.
- They can either be non-profit (pays out the SA only), with profit or unit linked.
- As there is bound to be a payment the cost of say a £1,000 SA will be higher than a term or whole of life policy.

Issuing a policy

- The process starts with the completion of a proposal form which can be on paper or electronic. This is likely to require a lot of medical and other information about the life assured. If the policy is to be issued on a life of another basis the life assured must give agreement to being insured and all medical details will refer to them rather than the proposer.
- The proposal is sent to the company's underwriters who make an assessment of the risk based on information given.
- The standard rate would be based on the proposed life assured's
    - Age
    - Smoker or non-smoker
    - Term of policy
    - Occupations and hobbies (looking out for hazardous ones such as free fall parachuting!)

Men used to pay more than women for life assurance as their life expectancy was lower. This was prohibited under an EU ruling and since December 12 2012 rates must be the same for men and women. Note that this still applies even though the UK is no longer in the EU.

- It may be accepted without any further enquiries. More usually the company will write to the life assured's doctor asking for more information. When the proposal indicates more serious concerns, they may refer the individual for a full medical with a doctor of their choice. This is paid for by the insurance company.
- If the company is happy to accept the risk they will send out an **acceptance letter**. This is in fact the company's formal offer of the terms on which they are prepared to accept this case.
- This could be at standard rates or when there is a greater risk due to past medical history, increased rates may apply. This is sometimes called a loaded premium.
- Alternatively they may put a lien on the policy. This is usually applied where the proposed life assured has had poor health but is recovering. The sum assured is reduced for the first few years but then reverts to the full amount.
- Sometimes the company will not be prepared to give any cover.
- Strictly speaking the policy comes into force when the first premium is paid. In practice as most payments are done by direct debit the plan comes into force when the proposer tells the company to go ahead.

- There is a duty for the proposed life assured to tell the truth to the insurance company. Under previous legislation this was very onerous and was felt to be out of The law was changed and non-disclosure now will fall into one of three groups:

    - Innocent
    - Negligent
    - Deliberate and without due care

This will be looked at in more detail when the claims procedure is considered

- As there is sometimes a delay between the acceptance letter being issued and the start of the policy, the life assured must disclose any changes in health in this period.

Proposers' rights to see their medical records

A proposed life assured has the right to see any medical evidence submitted by their doctor before it is sent to the underwriter

- If the life assured wishes to exercise this right, the report will remain with the GP for 21 days and the client can view at the surgery in that period.
- They can ask for it to be amended if they disagree with any facts although the GP can refuse to do this.

The client can see what the GP wrote at any time up to six months after the report was issued

Policy add-ons

There are a number of additional features which are offered and should be considered.

<u>Waiver of Premium (WOP)</u>

This would pay the premiums for the policy holder if they were unable to work due to accident or sickness provide the absence from work lasted 26 weeks.

<u>Terminal Illness</u>

This would enable the policy to be paid out if the life assured was diagnosed with a life expectancy of less than 12 months. However this would not be paid if the diagnosis was in the last 12 months of the policy.

If this is not included it may be possible to get the benefits from the policy whilst alive by using a **viatical settlement**. The life assured would sell the policy to this specialist company at a discount and the company would claim the full sum assured when the life assured died.

Compliance matters

- A suitability letter is required before the contract is concluded
- A 30 day cancellation period is required.

Policy maintenance and claims

Once the plan is in force the company cannot cancel it. Neither can rates be increased because the individual risk has increased, for example if the life assured's health later deteriorates.

A policy can also be assigned to another person or body. This means the person to whom it is assigned can act as the planholder and make a valid claim for the proceeds. This used to be common with endowment policies used to fund a mortgage when it would be assigned to the lender.

If a claim occurs the procedure is as follows:

- For an own life basis (policy holder and life assured) are the same the claim is made by the deceased's legal representatives (the executors or administrators of the estate)
- For life of another the plan holder makes the claim. For joint cases the survivor makes the claim
- In both instances the life company would want to see the death certificate and the original policy document. The latter is important since it is possible to assign the benefits to someone else and the original document is effectively proof of title. Where this is missing it is common for the claimant to be asked to sign an indemnity promising to repay the money if anyone else comes forward with a better claim.
- Most claims should go through relatively simply. If death occurred as a result of illness shortly after the plan started the company is likely to check that the information given about the life assured's health was accurate.
- This is where a decision has to be made if the non-disclosure was innocent, negligent or deliberate
- If the deceased had died of a heart attack but hadn’t disclosed they were having treatment for severe high blood pressure that would probably be considered deliberate and the claim would probably not be paid
- On the other hand consider someone who had seen their GP a few weeks before completing the proposal. The original reason for the referral might have seemed quite trivial and the doctor had prescribed antibiotics. However there was a much more serious underlying cause which came to light six months later and death subsequently occurred. Not stating that she had visited the doctor would be non-disclosure but as she was unaware that there was anything serious it would almost certainly be considered innocent non- disclosure.

“Unusual” deaths

Most policies have a suicide clause which means that if death is as a result of suicide that takes place in the first 12 months nothing will be payable. If suicide occurs after that then the full sum assured will be paid.

If the life assured disappears there is a common law presumption that after 7 years absence they can be declared dead. A court may declare them dead before that date if there is evidence that can be reasonably construed as meaning death has occurred.

Group life policies

Many companies offer life cover to all their employees. Depending on the number and the type of work they are involved in, the underwriter may be prepared to give cover with no medical details or individual proposals. This is known as free cover.

In almost every case the policy is written under a discretionary trust. This means the trustees have the absolute right to pay the benefits to anyone. This may seem a disadvantage but it gives a useful tax break. If the employee could insist that the death benefit was paid to their spouse it would be part of the deceased's estate and could be subject to Inheritance Tax. By writing it in trust the benefit can be paid directly to the beneficiary.

Trusts

- Trusts have a significant role in life assurance.
- For example let's say that Jean Black wants to insure her life to ensure that her children would be taken care of if she died. There is no insurable interest between parents and children so the only option is to insure her own life.
- If a claim is made this could cause two main problems. First it would be her legal representatives who would claim and they would put the money into her estate. This could incur an IHT liability or make the existing liability greater.
- Secondly it would cause delay in paying out the benefits since the money can't be distributed until the executors wind up the estate.

- The solution is to put the plan into trust. This means that the plan is owned by the trustees rather than Jean. She could in fact be a trustee but it would not be classed as her property. There should also another trustee since Jean won't be around if the policy results in a claim!
- On her death the trustees claim and the money is paid to them. They can therefore distribute the money quickly without it going into her estate

The main type of trusts that you will be tested on are as follows:

Absolute or Bare Trust

The key points are:

- There is at least one named beneficiary.
- Their rights to the trust property cannot be taken away or changed.
- They have the right to demand the trust property at any time provided they are over 18. This means that if the beneficiary is a minor child, once they reach 18 they can demand the property be given to them. They can also exercise this right if they are 16 and married.

Interest in Possession Trust

The key points are:

- There is at least one named beneficiary.
- They have a right to receive any income produced by the trust. The trustees cannot accumulate this income.

The most common IIP trust used in life assurance is called a **Flexible Power of Appointment Trust.** This identifies by name who will get the benefits. This individual is called the **default beneficiary**. It does allow the person who set it up to change these in the future. There is usually a list of **potential beneficiaries** described by family relationship, e.g. parents, children, grandchildren. Any of these can be made into default beneficiaries, that is they will be named as being entitled to the benefits

Another type of IIP trust is the **Life Interest Trust**. This is often used where there is a second marriage. For example a couple who have both been married before who both have children from their first marriages. The husband wishes to provide for his wife if he dies first. He could leave her a sum of money in his will but that then becomes her property and she is free to leave it to her children when she dies. To get round this problem a life interest trust could be set up in his will. A sum of money is placed into this and she can have the income from this but not the capital. On her death the money passes to his children from his first marriage. She is called the **life tenant** and his children are called the **remaindermen.**

Discretionary Trust

Under this type of trust no one has a right to income or capital. There is a list of beneficiaries usually described by family relationship. The trustees can choose to pay benefits to any of these as and when they choose.

Taxation of Trusts

A protection policy in trust does not normally cause the trustees any tax problems. No income is being produced and until death occurs the policy is of little value.

However a trust can hold assets that produce income or the trustees may sell an asset and this would give rise to a CGT liability. This is a very complex area but for this exam you just need to know the basics.

- Any income from an Absolute/Bare trust is the beneficiaries and any income is taxed on their own circumstances. They are liable to pay CGT and have the full Annual Allowance
- With all other trusts, the trustees are responsible for paying any tax.
- Unlike an individual a trust does not have a personal allowance and must pay income tax on every £ of income received on the trust's investments.
- With an IIP trust the trustees pay tax at basic rate on all income
- With a discretionary trust, the first £1,000 is taxed at basic rate and then any interest is taxed at 45% and dividends at 38.1%
- If income is paid to a beneficiary, the beneficiary will also be liable but can offset any income tax paid by the trustees against their own liability.
- Trustees pay CGT at the higher rate of 20%
- However, they have only half the annual exemption (£6,150).
- There may be a "periodic" charge on the trust assets every 10 years.
- The trustees may have to pay an "exit charge" when property is passed to a beneficiary

Taxation of life policies

There is no tax relief on life policy premiums taken out by individuals. Policies issued prior to April 13 1984 will still attract tax relief at 12.5% on premiums but clearly there are very few of these policies still in existence and the government is proposing to abolish this.

Tax relief was also available on premiums paid into a term policy set up under a Personal Pension. This was abolished in November 2006.

There is no income tax liability on death benefits from a term policy.

Qualifying and non-qualifying policies

Whole of life policies (and endowments) are classified for tax purposes into qualifying and non-qualifying policies.

All benefits from a qualifying policy are free from any personal tax liability. Benefits from non-qualifying policies may be subject to an income tax charge.

For a plan to be qualifying it must meet the following requirements:

- A term of at least 10 years
- Premiums paid on a regular basis and at least annually.
- Premiums in one year are no more than double of premiums in another year. In other words if the premium was £600 in one year it could be increased to a maximum of £1,200
- Death benefits must be at least 75% of premiums paid over life of the plan (or until 75 for a whole of life policy)
- Have a maximum premium of £3,600 (only for policies taken out after April 2012)

A qualifying policy can become non-qualifying if:

- It is surrendered, paid up or assigned in return for a cash payment
- In the first 10 years or ¾ of the term if less.

Tax becomes payable when a chargeable event occurs. This is likely to be:

- Death
- Surrender
- Maturity
- Assignment in return for cash

Income tax is charged on any gain which is the difference between what the planholder received and what they had paid in premiums. However if a death claim occurs the value of the policy is not the death benefit but the surrender value of the policy the day before death occurred. This is likely to be very low.

As income tax is deemed to have been paid at basic rate only higher and additional rate tax payers will face an automatic charge.

This is 20% for higher (40%) tax payers and 25% for additional (45%) rate tax payers.

Basic rate tax payers should not normally have to pay any more tax unless the gain takes them into the higher rate band.

There is one time when Capital gains Tax is charged on the gain and this is when someone has bought an existing policy which is almost always a with profit endowment.

Their gain is the difference between maturity value and the purchase price and premiums paid since it was sold.

Inheritance tax (IHT)

IHT is a not just a death tax, it is a tax on the transfer of property both in life or on death. It is usually only paid on death although we need to take into account any lifetime gifts as well.

Gifts made in life will be either

- Exempt
- Potentially Exempt
- Chargeable Lifetime transfers

Gifts on death will be either:

- Exempt
- Chargeable

It is probably easiest to look at transfers on death first.

The only two exempt gifts on death are:
- Gift to spouse or civil partner
- Gifts to charities.

If Mr. Brown leaves £5 million to his wife in his will. This would be totally exempt from IHT.

Any other gifts are chargeable. There is a Nil Rate Band (NRB) of £325,000 and all gifts in excess of this are charged at 40%

Alan is divorced. He dies with an estate of £525,000 which is left to his children. This is £200K in excess of the NRB so tax is chargeable at 40% giving a tax bill of £80,000. This must be paid before the estate can be distributed.

If the deceased had passed all property to the spouse this would have been exempt but they would have effectively wasted the NRB. If this happens any unused NRB can be transferred to the surviving spouse

Simon transferred all his property to his wife Alice on his death. When she died in 20/21 her estate was £500K. As Simon didn't use his NRB, she can inherit it so the NRB is twice the standard amount in the year of death. This means her NRB is £650,000. The estate is below this so no tax is payable.

To qualify for the transferable NRB the following conditions must be met:

- The second death must occur after October 8 2007
- It doesn't matter when the first death occurred

- The couple must have been married/in civil partnership at the time of the first death
- The maximum NRB that can be transferred is 100% so someone who remarried after losing their wife/husband can take the unused NRB from both spouses but this cannot be more than £325,000 giving a maximum total of £650,000.
- The transfer must be claimed within two years of the second death

Residential Nil Rate Band (RNRB)

This is an additional NRB of £175,000 which can be claimed if the home owned by the deceased is left to a **direct descendent**. These are the children, grandchildren, step children and adopted children. It also includes the spouses of these.

Like the standard NRB, RNRB can be transferred between spouses which can double it to £350,000 and effectively give a combined NRB of £1 million.

RNRB will be reduced if the total estate of the deceased is more than £2 million. It is then reduced by £1 for every £2 above £2 million.

Let's now look at the impact of lifetime gifts. These are either:

- Exempt
- Potentially Exempt
- Chargeable

The main exempt gifts are:

- Unlimited amounts to spouse/civil partner or charity
- Annual exemption per individual donor of £3,000. If not made one year can be carried forward to the following year
- Small gifts of £250 to unlimited number of individuals
- Special limits on gifts made on marriage (these are in addition to the annual exemption.) They will be shown in the tax tables given to you in the exam
- Gifts made out of normal expenditure.

An exempt transfer will never have any IHT liability

Potentially Exempt Transfers (PETS)

- As the name implies these are not exempt but could become exempt.
- They are gifts made to persons that are not exempt
- A lifetime gift to an absolute trust is also a PET
- They will become exempt if the donor survives 7 years after making the gift
- If the donor dies before then they are treated as if they are the first gifts from the estate on death. In effect a PET reduces the NRB available to the estate for the next seven years

- For example Bill dies with an estate of £600,000. Five years earlier he had made a PET of £100,000 to his son.
- The PET has failed so it is treated as being the first gift from the estate and therefore reduces the NRB by £100K. The estate then only has an NRB of £225K
- If the PET was for £375K, it would have wiped out the NRB and the excess of £50K would be chargeable on the recipient who would be taxed at 40%
- If the PET was made more than three years ago, taper relief could be used to reduce the amount of tax paid by the recipient. Taper relief can only ever reduce tax payable a recipient. It can never reduce the value of a PET,
- Where there is more than one PET outstanding on death, they are dealt with in date order from the earliest to the latest.
- PET do not reduce the amount of the RNRB.

Chargeable Lifetime transfers

- These are mainly gifts made to trusts
- Tax at 20% is payable immediately if the gift exceeds the NRB
- This is cumulative so any previous CLTs made in the last seven years will be taken into consideration.
- Again CLT do not affect the amount of any RNRB

Paying for IHT

- The usual way is to take out a whole of life policy on the life(s) of the people whose death will trigger the tax.
- The sum assured should be the amount of tax payable *on the assumption that the estate has the full NRB and RNRB*
- If it is a joint life policy it should be on a second death basis
- The plan should be written in trust for the people who will have to pay the tax.

If significant PETs or CLT have been made the estate may have no NRB. This means for seven years after the gift, an increased liability £130,000 will be incurred. (£325,000 x 40%) Once seven years has passed the estate has the full NRB. The solution is to take out a **seven year level term policy for £130,000.**

Where a recipient is liable for tax a **Gift inter Vivos** policy could be taken out. This is a decreasing term policy that runs for seven years. The initial Sum Assured should be the amount of tax and it will reduce in line with taper relief. After seven years the gift will become exempt.

Non-Life Protection

The main ones to consider are:

- Critical Illness
- Permanent Health Insurance (PHI)
- Accident, Sickness & unemployment

Critical Illness

This is a contract that pays out the agreed sum assured if:

- The assured life is diagnosed
- With an illness specified in the policy

- There is usually a condition that the insured person must survive 28 days from diagnosis for the claim to be paid. If death occurs earlier a nominal amount may be paid. It is important to stress that it is not a life policy so the death of the insured person will not result in a claim
- Critical Illness policies can be set up as a term policy or a whole of life.
- Premiums can be increased but this can only be as a result of general experience. The company cannot increase the rate for an individual because their health has deteriorated.

- Policies can be on a stand-alone basis or be added on to a life policy
- This is known as an **accelerated basis**. The plan will pay out on the earlier event of a death or critical illness. The plan then comes to end. The CI part of the premium will be reviewable in the light of general experience.
- There is a special type of trust used with a combined life/CI policy called a **split trust**. If a CI claim is made the money is paid direct to the planholder whereas with a death claim it is paid into the trust.

Underwriting and policy issue is similar to life policies.

Permanent Health Insurance (PHI)/Income Protection

- This is a contract that covers the loss of long term income.
- The term of the plan is normally the whole of the insured's working life so plans commonly run until 60 or 65.
- A claim is triggered if the insured person is unable to work as a result of accident or sickness.
- There are therefore two components of the claim condition. Having an accident or being ill isn't sufficient to pay the claim. It must stop you working.
- All PHI policies have a deferred period. That is the time the insured person has to be off work for a claim to be paid. This usually is the same as the amount of sick pay the person gets. If their employer would pay them for 6 months the plan will have a 26 week deferred period. If sick pay lasts for a year 52 weeks would be appropriate.
- The longer the deferred period, the lower the premium.
- A self employed person may require a shorter deferred period as they don't get sick pay. However the minimum period available is usually 8 weeks or more rarely 4 weeks
- The benefit is usually expressed as an amount of money that is paid monthly or annually

Once a claim is accepted it will be paid until the earlier of:

- Being able to return to work
- The policy comes to an end
- The death of the individual

A PHI policy can have multiple claims. A CI policy will end when the claim is made. With PHI it is possible to have one claim in your 20's, then resume work and have another claim in your 40's.

Underwriting the plan

- The process is similar to the issue of a life policy.
- Age is a key factor in determining the rate but the proposer's occupation is likely to be far more significant than a life policy.
- The amount that can be insured is usually limited to a percentage of your earnings. Primarily because the insurer wants to avoid someone being better off out of work than in work.
- The definition of being unable to work will either be on a "your job" or "any job" basis. The latter is preferable although the company may insist on the former particularly for jobs where a slight deterioration in health would stop you doing your job, e.g. an airline pilot, but you would still be fit enough to do another job.
- It is usually possible to have some form of escalation so that the benefits increase once in payment.
- It is also common to have premiums suspended whilst a claim is being paid

Accident, sickness and unemployment policies

These come in a variety of combinations, Personal Accident only, Personal Accident and Sickness, Personal accident, sickness and unemployment.

There are common features to all of them.

- They pay an income in the event of accident, sickness or unemployment depending on the policy type.
- The deferred period is usually shorter than PHI.
- Benefits are paid for a maximum of two years.
- They are annual policies

This last point is important since it means the insured must declare any changes in health at each renewal. The company may then decide not to offer cover. Similarly if a claim is made as a result of sickness, whilst the company will pay it may refuse to offer future cover at next renewal.

These plans are less expensive than PHI policies.

Banks and other lenders sold these plans as package products as part of a mortgage or loans. They were heavily criticised for not warning customers about exclusions due to pre-existing conditions or the fact that it was almost impossible for a self-employed person to claim unemployment cover.

As a result they are now prohibited from offering this cover at point of sale for up to seven days after arranging the loan or producing a personal illustration.

Private medical Insurance (PMI)

This covers the cost of having non NHS treatment. It generally only covers acute cases as opposed to chronic or continuing illnesses.

Most claims start with a referral from the GP to a specialist. The insurance will normally cover the costs of all medical treatment plus hospital "accommodation" costs. It is termed a policy of indemnity since it will only pay out what has been incurred. There is usually an excess of at least £100 for each claim.

Underwriting is quite strict particularly around any pre-existing illnesses. It is common to either exclude these completely or for a set number of years. Once accepted the plans cannot be cancelled but premiums are reviewable on a general basis and these normally increase each year.

Long Term Care

The Government is drawing up plans to reform the funding of Long Term Care. For the moment these are the main rules.

An individual who becomes unable to look after themselves may need to enter a care home. These are usually quite expensive and even if someone has a high level of savings these are likely to be exhausted quite rapidly.

The local authority has a key role since every person has a right to request a care assessment. This establishes whether that person *needs* care. At this stage there is no assessment of their financial ability to pay.

A care assessment tests how many **Activities of daily living** the individual can do. These are:

- Walking
- Dressing
- Washing
- Toileting
- Transfer
- Eating

Whether the individual then qualifies for financial help will depend on two factors:

- Their income
- Their capital

You should note that there are different rules for England, Wales, Scotland and Northern Ireland. These are the English rules. They are in reality much more complex than this.

If your income is sufficient to pay the fees then you get no help at all. Should your income be insufficient a capital test is applied.

- If your capital is more than £23,250 you get no help and are expected to run your savings down.
- If your capital is less than £14,250 you will get all the fees paid
- If your capital is between these two figures each £250 in excess of £14,250 is deemed to produce £1 of income. This is then added to your other income to establish whether you have sufficient income to pay the fees. If there is still a shortfall then you will have your fees paid
- However if you do qualify you must give up all your income apart from £24.90 a week
- Financial support only covers Personal Care costs and not “hotel costs”. The latter is the costs of accommodation meals.

Note that these rules apply only in England. There are slightly different rules for Scotland, Wales & Northern Ireland.

What is capital?

In practice this is very complicated but two points should be noted.

- Surrender values of life policies are ignored. This means an Insurance Bond worth £200,000 is not considered.
- The applicant's home is taken into consideration but is ignored if their spouse or another dependant lives there.
- Even if the house is taken into consideration the normal practice is for the local authority to put a charge on it. They then pay the fees and recover these from the estate when the individual dies

Finally it is no use giving all your property away before applying for help. The LA will consider that deliberate deprivation and consider that you still own it.

Insuring Long Term Care

In principle it should be possible to insure against the risk of having to go into LTC as not everyone will need this. These would be described as “pre funded plans”. In practice no products are currently available since take up was very low when companies tried to market these. Existing policies will still be honoured.

The main reasons why they proved difficult to sell were mainly:

- Premiums were reviewable and as these increased many plans were cancelled.
- For insurance to work you need a good cross section of insured individuals but as there was insufficient take up these plans were unlikely to be profitable
- Women are far more likely than men to need LTC but you cannot now discriminate on grounds of gender

On plan that does remain available is the immediate needs annuity. This pays a set income in return for a lump sum investment. If the fees are paid directly to the care provider the individual will not be taxed on the income.

This is not a pre funded plan and relies on there being sufficient capital to buy the annuity but it does insure the risk of your capital being exhausted as it guarantees the fees will be payable for as long as you are in the home.

Using the home to pay fees

The individual's home is their largest asset and can be used to release funds.

- It could be rented out so that the rent would go towards the care fees whilst the property could be sold after death.
- A Lifetime Mortgage could be taken out. This is a mortgage where no interest or capital is paid. The debt rolls up and is paid off when the borrower dies by the sale of the house. Most plans have a condition that state that the loan will never exceed the value of the property.
- A Home Reversion plan. The owner "sells" part of the home to the reversion company. This is usually at a discount so selling 50% of the house might only produce 30% of the value. No interest or rent is paid and the reversion company recovers its money when the borrower dies

Employment benefits

Most employees will get some financial protection through their employer. The most common is sick pay. The length of time an employer will pay this will vary but it means there should be little financial impact on the employee if they have short term illness.

Some employers may pay Permanent Health Insurance so that when sick pay runs out their PHI will kick in. One importance difference is that the employee will pay tax on this income whereas payments under individual PHI are tax free.

Another common benefit is Death in Service. This pays out a lump sum and you will remember from the earlier section this is paid under a discretionary trust so it is not part of the deceased's estate.

Final salary pension schemes will usually provide a spouse's and/or dependent's pension. If the employee dies their spouse will get a pension for the rest of their life.

Employees may also get private health cover to pay for the cost of private treatment. This may be free or be offered at a discounted price. Unlike the other benefits this is a taxable benefit in kind but there is no tax when the benefits are paid.

Business Protection

There are two main policies:

- Key Person Insurance
- Shareholder/Director Insurance

Key Person Insurance protects the business against loss of profits caused by the death (or critical illness) of a key employee. This could be someone like the chief designer who is crucial to the success of the business and if he or she were to die, the profits of the business would fall.

The sum assured is usually established by this formula:

$$\frac{\text{Key Person's earnings}}{\text{Total wage bill of the business}} \times \text{Gross Profits}$$

If the KP's earnings represented 10% of the total wage bill then it would be assumed he produced 10% of the profits. This would be multiplied by the number of years it was felt profits would reduce, usually a maximum of 5 to get the sum assured.

For example if the KP's share of the profits on an annual basis was £100,000, the company would take out a five year level term policy on the life of the KP for £500,000.

Shareholder/Director Insurance is designed to protect the directors or partners against the death of another partner or director.

A partner or director's share of the business is considered part of their assets. When they retire they will normally sell this to a new partner or director. If though they die in office the share of a partnership or the shares of a director will fall into their estate.

This causes a problem to both the surviving partners/directors and the deceased's family. The latter wants cash for their share and the former doesn't want to be in partnership with the deceased's estate. The deceased's estate could sell their share but that might result in the partners/directors being in business with someone they didn't choose. Note that this problem will only apply to directors of private companies as their shares aren't tradable in the same way as shares in a public company.

The first step is to set up some agreement that will lay down the procedure that must be followed if a partner/director dies. There are three main methods:

- Automatic accrual
- Buy and Sell
- Cross Option

With automatic accrual the share/shares will automatically go to the survivor who will have to pay for these. This is normally only appropriate where there are just two directors or partners.

With Buy and Sell the deceased's estate must sell and the surviving partners/directors must buy the share at an agreed price.

Cross Option works in a similar way but it is an option rather than an obligation. In other words the deceased's estate has an option to sell which they could choose not to exercise. This has an IHT tax benefit since it means the deceased's share would not be included in their estate.

Whichever method is chosen the surviving partners/directors need to be able to provide the money to make the purchase. This is done with a term policy and this can be set up in different ways.

- Each partner can insure his or her own life writing it in trust for the survivors
- A partner could insure the life of another partner.
- The business could insure the lives of the partners/directors