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Factsheet

Life insurance checklist

Outline

A life insurance policy provides financial protection for your family or business if you pass away. This factsheet highlights the benefits of taking out a policy, outlines the types of insurance that are available to consumers, and explores the inheritance tax (IHT) implications of a payout.

What is life insurance?

Life insurance typically sees a tax-free lump sum (or occasionally regular payments depending on the policy type) paid out to designated beneficiaries if the policyholder passes away. In return for this cover, policyholders pay a monthly premium. The amount is determined by a number of factors including age, gender, lifestyle, state of health, and the type of policy you choose, alongside the cover amount.

Why take out a policy?

A life insurance policy provides a financial safety net, enabling family members to cover any financial liabilities if the policyholder were to pass away. It also provides peace of mind for the insured, given that their loved ones will be protected and provided for. Policies can be particularly valuable if the insured is the sole/main earner in the family, or if they are a stay-at-home parent looking after a child/children. A lump sum (or regular payment) payout can cover liabilities – such as mortgage repayments, or childcare costs in the event of the loss of a stay-at-home parent – upon the death of the insured.

Life insurance can also help to protect your company if you are a business owner. There are a number of different policies available to suit a range of needs and individual circumstances. The main policy types are covered in this factsheet.

Term insurance

Term policies are for a fixed term, allowing the policyholder to insure themselves for a set amount and timeframe, in exchange for monthly premiums. If the policyholder passes away within the set period then their beneficiaries receive the payout. If they do not, no payout is issued. There are three types of term insurance: level, decreasing, and increasing. Level-term insurance, which is the most common form of term insurance, sees the payout amount stay the same throughout the length of the policy term. Decreasing-level insurance means that your cover reduces as the term progresses. This is typically used to cover repayment mortgage debts that will reduce over time. Increasing-level insurance sees the cover amount increase in line with inflation.

Whole-of-life

Also known as life assurance, a whole-of-life policy is guaranteed to pay out when the holder dies (as long as monthly premiums are met). Because these policies are guaranteed to pay out at some point, premiums tend to be more expensive than for fixed-term cover.

Family income benefit

A family income benefit insurance policy is a type of term cover that typically sees regular (usually monthly) tax-free income payments made to family members (although a lump sum option can also be requested).

In the event of the policyholder's death, the insurer will pay out income payments for the remainder of the policy term.

For example, you could decide to set your cover at £2,800 per month and take out a 20-year decreasing term. If you were to die five years into the term, the insurer would pay out £2,800 each month for the remaining 15 years (or £2,800 × 15 if a lump sum payout is requested).

Family income benefit insurance could be particularly well-suited for a family that requires a large amount of cover initially (for example, to cover education or childcare costs), which will then decrease over time as the family's financial liability reduces.

Key person protection

Key person cover may be applicable if you are a business owner and wish to protect against the financial consequences of the death – or critical illness – of an employee who performs a crucial role. Payouts can be used to fund a replacement or keep trading. Usually these policies are written on a short-term basis and reviewed regularly, which leads to the premiums being cost-effective. Business owners may be able to benefit from very generous tax breaks, but it is a good idea to take specific tax advice.

Shareholder protection

Another form of business protection provides cover in the event of the death of a key business shareholder. Without the safety net of an insurance policy, a shareholder's equity could become part of their estate upon death.

In such circumstances, their shares would pass on to their beneficiaries, who could opt to sell this inherited stake to a third party. A shareholder protection policy payout provides the funds needed for the remaining company owners to purchase the equity of the shareholder who has passed away, allowing the existing shareholders to maintain control of the business. Shareholder protection can also apply if the part-owner is unable to work due to critical illness.

Critical illness cover

Critical illness cover is often sold alongside a regular life insurance policy, and it works in a similar way. It can help to cover loss of earnings if you need to take time off work for treatment or recovery due to severe illness. You can choose the amount you wish to be covered for, and the length of the term. Most insurers typically cover illnesses including cancer, heart attacks, and degenerative diseases such as Alzheimer's and Parkinson's. Critical illness cover pays out once as a lump sum if the claim is successful.

Summary of life insurance policies

Type of insurance	Beneficial for
Term	Those seeking cover for a set period of time to cover specific liabilities, such as loss of income or extra costs associated with a death within the household
Whole-of-life	Providing a guaranteed lump sum safety net for family members throughout the life of the insured
Family income benefit	Covering household liabilities that are expected to reduce over time. Monthly income provides a simple way of budgeting (although a lump sum can be requested), and policies are often cheaper than term policies
Key person	Small businesses where the death of the key person would have a significant impact on the company's performance
Shareholder protection	Providing a succession safety net for small or medium-sized businesses
Critical illness	Covering financial liabilities in the event of being unable to work. May be particularly appropriate for covering medical costs and repayment mortgage liabilities for a set period of time

Joint life insurance considerations

A joint life insurance policy covers two lives, but the cover is often on a 'first death' basis. The chosen amount of cover is paid out if one of the policyholders dies, but the policy ends, leaving the surviving partner without cover. A 'second death' option is sometimes used for IHT purposes. A joint policy can be cheaper than taking out two single life policies for the same amount of cover. But, a couple might not need the same amount of cover. For example, a main/sole earner might need less than a stay-at-home parent. In this case, it might be cheaper to have two separate policies.

Inheritance tax liabilities

A payout can increase IHT liabilities, depending on your individual circumstances. IHT applies if an estate exceeds the threshold of £325,000, which is known as the nil-rate band, or NRB. However, assets left to a spouse or civil partner are exempt from IHT. Married couples and civil partners may also be able to benefit from a combined inheritance tax exempt threshold of up to £1,000,000, as they can inherit each other's nil-rate bands, and main residence allowances, which are £175,000 for each spouse/civil partner.

Depending on the IHT threshold of a couple, a lump sump life insurance payout could lead to a substantial IHT bill for family members upon the death of the surviving spouse/partner. This can be avoided by writing a policy into trust (see below).

Writing a policy into trust

By writing a policy into a discretionary trust, and designating children as beneficiaries, the insurance payout will not be classed as part of the taxable estate, meaning you can potentially prevent a significant IHT charge. Insurers tend to offer the option of writing a policy into trust at the time of taking out a policy, but it can also be put into trust at a later date, usually with the help of a financial adviser.

Writing a policy into trust can be particularly important for cohabiting couples who are unmarried/not in civil partnerships, as a cohabiting partner doesn't automatically benefit from inheriting their partner's estate as married couples/civil partners do. Making a will, and writing the policy into trust, will ensure the payout goes to the cohabiting partner (if this is the desired outcome), while also placing it outside of the estate for IHT purposes.

Writing a policy into trust also provides greater control, ensuring the payout is used for its original purposes in line with the insured's wishes – for example, future education. It also provides faster access to payout benefits by avoiding the probate process, which can be lengthy.

Write a policy into trust and save on IHT

Example: Estate value of £750,000 (excluding personal pensions); £500,000 life insurance policy with children named as beneficiaries.
Assumptions: married couple; full nil-rate bands/NRBs available (2× £325,000 standard NRB and 2× £175,000 residence NRB).

Illustrative figures	Life insurance written in trust	Life insurance NOT in trust
Estate value	£ 750,000	£ 1,250,000
IHT allowances	£ 1,000,000	£ 1,000,000
Estate subject to 40% IHT	–	£ 250,000
Potential IHT liability	–	£ 100,000

Life insurance with Lumin

A financial adviser can help you find the cover that is best suited to your individual needs. The Lumin team analyses and compares a large number of different policies from various providers, in order to get the most competitive cover that is the right fit for your specific circumstances. A Lumin adviser can also explain the benefits of setting cover up in trust for IHT purposes.

In expert hands with Lumin

Lumin is a leading independent financial adviser headquartered in St Albans, with particular reach across London and the South East. We offer trusted and professional advice on pensions and retirement, investments, inheritance and tax planning, financial protection for individuals and businesses, and mortgages. Lumin's financial plans are geared toward growing, or protecting, wealth by optimising our clients' income, assets, tax burden and financial security. Whatever your financial ambitions, you can count on our expertise to provide peace of mind. We are backed by VZ Group, the leading independent financial services provider in Switzerland.

Financial advice made easy: Scan the QR code to arrange a complimentary meeting over a coffee.

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