A detailed examination

SIMON MCKIE analyses an interesting inheritance tax planning product.

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An Isle of Man assurance company offers an arrangement using a bond consisting of a group of endowment assurance policies which are issued to a policyholder who then assigns the policies on trusts. Compared to conventional discounted gift trusts, the arrangement offers the additional benefit of allowing the original policyholder's right to cash benefits to be deferred indefinitely without creating a further transfer of value. The cost of this additional flexibility is that there is no 'discount' on the measure of the initial transfer of value. However, like much inheritance tax planning based on insurance, the arrangement is heavily dependent on HMRC adopting an over-generous construction of the relevant law and I therefore thought that it might be a useful exercise to examine a product such as this in detail and review the tax implications of it. Relevant points are as follows.

- *The policies*. The endowment policies (the 'policies') confer rights to benefits on surrender (the 'surrender benefit'), on the maturity of the policy on a fixed date (the 'maturity date' and the 'maturity benefit') and on the death of the last of the lives assured. The maturity date may be postponed at the option of the policyholder from time to time (the 'extension right'). On entering into the arrangement, a set of policies is specified with maturity dates designed to generate payments at regular fixed dates.
- *The settlement*. The trusts are at the heart of the arrangements. The company provides various forms of settlement including a children's settlement (the 'settlement') which is most commonly used.
- *The trusts of the settlement – the clause 3 powers*. Under clause 3, the trustees have a wide power during the trust period to declare trusts over one or more policies for the benefit of all or any one or more of the 'appointed class' which includes the children and remoter descendants of the original policyholder. In default of an appointment under this power, the trustees have broad discretionary powers during the trust period 'in relation to each policy' to transfer or apply the trust capital to or for the benefit of the appointed class. No power under clause 3 may be exercised so as to benefit the original policyholder.'
- *The trusts of the settlement – the clause 4 trusts*. Subject to any exercise of the powers conferred by clause 3, if the 'relevant event' occurs the trustees are to hold each policy for such of the 'beneficiaries' (the children of the original policyholder) who are living on the 'relevant date' in equal shares (the 'clause 4 trusts'). Subject to the exercise of the clause 3 powers, the beneficiaries have equal interests in possession in the settled property during the trust period.
- *The reversionary interest*. Subject to clauses 3 and 4, the trustees are to hold the trust fund and the income thereof for the settlor absolutely (the 'reversionary interest').

KEY POINTS

- The structure of the policies under review.
- HMRC's approach to insurance policies and the pre-owned assets charge.
- The treatment of reversionary interests.
- Calculating the ten-yearly charges.
- The advancement of the trust fund and surrender of policies.

The trust period, event and date

The 'relevant event' in relation to each policy means the death of the original policyholder before the maturity date. The trust period in relation to each policy means the period commencing on the day the settlement is made and ending on the earlier of:

(a) 80 years after the making of the settlement;
(b) the death of the last survivor of the beneficiaries and their descendants; or
(c) the relevant event ceasing to be capable of occurring without actually having occurred.

If the original policyholder lives until the maturity date of a policy the relevant event in respect of that policy cannot then occur and the trust period in respect of it will end.

Thus, if the original policyholder is alive at the maturity date of a policy and the clause 3 powers have not been exercised, he will become absolutely entitled to that policy under the reversionary interests at the point at which the maturity benefit under that policy arises. If, however, the original policyholder dies before the maturity date the trust period will determine on the earlier of the death of the last survivor of the beneficiaries and their descendants and the expiration of 80 years.

If the trustees exercise the extension right, the effect – in respect of the policy concerned – will be that the trust period will be extended and therefore it will be more likely that the settlor will die before the maturity benefit becomes payable.

The issue and assignment

No significant inheritance tax charge will arise on the issue of the policies.

The assignment of the policies on the trusts of the settlement is a disposition which is a transfer of value because it results in a decrease in the value of the estate of the original policyholder. Determining the amount of the transfer is complicated, but it is likely to be not materially less than the premium paid in respect of the policy.

All references in this article are to IHTA 1984 unless otherwise stated and under s 2 the assignment will be an immediately chargeable transfer. To the extent that the transfer exceeds the original policyholder's unutilised nil-rate band it will lead to an immediate charge to inheritance tax. That means that the arrangement is primarily suitable only for small transfers.

If the settlor has made a potentially exempt transfer before making the settlement and dies within seven years that prior transfer will be chargeable. That would use up some part of the original policyholder's available nil-rate band with the result that the chargeable transfer arising on the making of the settlement might itself bear inheritance tax and there would be a further effect on the rate of tax arising on future decennial and exit charges under s 64 and s 65.

Where a chargeable event occurs in relation to a life insurance policy, a chargeable event gain may arise under ITTOIA 2005, s 462(1). The assignment of all of the rights under a policy or contract is a chargeable event, but only if the assignment is for money or money's worth (ITTOIA 2005, s 484(1)(a)(ii)). The assignment on the trusts of the settlement is not for money or money's worth and therefore is not a chargeable event.

FA 2004, s 84 and Sch 15 paras 8 and 9 provide that a pre-owned assets charge may arise in respect of a settlement where:

> 'the terms of a settlement, as they affect any property comprised in the settlement, are such that any income arising from the property would be treated by … ITTOIA 2005, s 624 as income of a person who is … the settlor.'

Although the charge operates by reference to ITTOIA 2005, 'settlement' and 'settled property' have the same meaning as in IHTA 1984.

Settlement and settled property

The definition of 'settlement' for inheritance tax purposes is given by s 43. It is clear that this section looks at the property which is subjected to trusts and not at the equitable interests in that property arising under the trusts. So in respect of the arrangement there will be a settlement for the purposes of s 43 if the policies are held in trust for persons in succession or for any persons subject to a contingency and, if that condition is satisfied, that property will be property comprised in the settlement and therefore 'settled property' in respect of that settlement. At the point at which a policy is assigned on the trusts of the settlement it is clear that the policies are both held in trust for persons in succession and are held for a person subject to a contingency. During the trust period a policy is held on the clause 4 trusts subject to the clause 3 powers. If the settlor survives to the maturity date (a contingency) it will become held on the trusts of the reversionary interest (a succession). The whole policy is, therefore, settled property. It is only when, and if, that contingency is satisfied by the survival of the original policyholder to the maturity date, that a policy will cease to be held for persons in succession because it will then be held for the original policyholder absolutely and will cease to be settled property.

"In HMRC's view the assignment is not a gift with reservation. If that view were correct, the pre-owned assets charge would apply."

So until and unless the trustees exercise their clause 3 powers to create trusts under which the original policyholder cannot take any present or future benefit, the original policyholder dies, or he survives to the maturity date, a pre-owned assets charge will arise unless some other provision provides an exemption. FA 2004, Sch 15 para 13(3) and (5) provides that para 8 is not to apply at any time when the settled property is property subject to a reservation. We shall see that the property is property subject to a reservation so it will be exempted from the pre-owned assets charge.

However, as we shall also see, in HMRC's view the assignment is not a gift with reservation. If that view were correct, the pre-owned assets tax charge (POAT) would apply.

HMRC's approach

Correspondence between HMRC and the Association of British Insurers was published in September 2004 concerning the pre-owned assets charge and insurance policies. In this correspondence, HMRC's approach was to regard the 'property' referred to in FA 2004, Sch 15 para 8 not as being the property over which trusts are declared but rather the interests in that property which arise under those trusts.

In 2004, HMRC's Capital Taxes Office (CTO) stated that:

> 'Where a settlor settles intangible property into a settlement and subject to … trusts ... [for other persons] the remaining interests in that intangible property are held in trust for the settlor absolutely, then, notwithstanding the reference to ITTOIA 2005, s 624 in Sch 15 para 8:
>
> (1) the intangible property which forms the trust fund of the settlement is not itself "the property" or "the relevant property" referred to in paragraph 8;
> (2) "the property" and "the relevant property" consist of the rights or interests of the beneficiaries in the intangible property, which are separate and distinct from the reversionary rights or interests held on trust for the settlor ...;
> (3) the settlor cannot benefit from "the property" held for the beneficiaries and so there is no "relevant property";
> (4) where the settlor's interest is itself comprised in a separate settlement or where it is held upon a bare trust then that interest in the relevant property would form part of his estate within the terms of the exemption in Sch 15 para 11(1). There would therefore be total freedom from the POAT charge.'

"There must be a distinction between the property which is subjected to the trusts and the interests arising under those trusts."

It is clearly not correct to say that intangible property which forms the trust fund of the settlement is not itself 'the property' or 'the relevant property' referred to in Sch 15 para 8. An interest arising under the settlement clearly cannot be property comprised in that settlement. There must be a distinction between the property which is subjected to the trusts of the settlement and the interests arising under those trusts. The clause 3 powers and the trusts of clause 4 are expressed to apply in respect of a whole policy. The trusts of the reversionary interest apply to the whole trust fund. The assignment does not create a bare trust in the property. It creates interests in succession subject to a contingency. The CTO's construction is, therefore, quite untenable.

The company has very naturally relied on the apparently unequivocal nature of the CTO's view. There is a generic problem for all insurance companies attempting to create inheritance tax planning products caused by the very low quality of recent legislation. HMRC have attempted to deal with the problem by adopting over-generous constructions of the law. That leaves the taxpayer in a very difficult position. If HMRC were to resile from its position in respect of a particular implementation of the arrangement the taxpayer concerned would have to rely on the uncertain remedy of judicial review.

Exercise of the extension rights

As the exercise by the trustees of the extension right is not a disposition by the original policyholder it is not a transfer of value by him under s 3; and as the body of trustees act in their capacity as trustees and not as individuals, the exercise is not a chargeable transfer by the trustees under s 2. Nor is there an exit charge under s 65.

The vesting of reversions

Section 65 imposes an 'exit charge' where the property comprised in a settlement ceases to be relevant property. When the reversionary interest vests, the original policyholder will become absolutely entitled to that policy which will therefore cease to be settled property, and thus to be relevant property, because it will no longer be held in trust for persons in succession or for any person subject to a contingency.

A letter from HMRC in August 2006 says, however, that in respect of arrangements where it can be established that the reversionary interest carved out and held on trust for the settlor is quite separate and distinct from the rights or interests of those who might benefit under the trusts settled by the gift, HMRC would regard that reversionary interest as a bare trust for the settlor and not as relevant property.

HMRC's view is both surprising and untenable.

Before the vesting, the policy concerned is held for persons in succession and is therefore relevant property. After the vesting, it is clear that it is not so held and is therefore not relevant property. The conditions for an exit charge under s 65 are clearly satisfied.

Death of the original policyholder

Will there be property subject to a reservation within s 102 by reason of the arrangement? The key to applying s 102 is to identify the property which is the subject of the gift.

The whole policy is settled and, therefore, is the subject of the gift. It is not just some of the rights arising under the policies which are assigned to the trustees and subjected to the trusts of the settlement but rather the policies in their entirety. Once the policies have been subjected to the trusts, the original policyholder's interest in those policies is contingent on events outside his control (the time of his death and the exercise by the trustees of the extension rights) one of which is within the control of the trustees (the exercise of the extension rights).

It is true that inheritance tax, following estate duty, recognises that it is possible to carve out an interest in property prior to making a gift and that, in that case, the donated property is the property subject to the carved out interest. *Ingram & Palmer-Tomkinson (Lady Ingram's Executors) v*

CIR [1999] STC 37 is an example of that, but it concerned a current and vested interest in property (a lease) which was not subjected to the trusts to which the settled property (the freehold reversion) was subjected. A similar point could be made in relation to the New South Wales stamp duties case of *Munro v Commissioners of Stamp Duties of New South Wales* TC [1934] AC 61. That is very different to the arrangement, where the reversionary interest arises under the trusts of the settlement, is contingent and can be indefinitely deferred by an exercise of the trustees' powers.

On 18 May 1987, however, the Inland Revenue (as it then was) published its views on the operation of the gifts with reservation rules saying:

> 'In the case where a gift is made into trust, the retention by the settlor (donor) of a reversionary interest under the trust is not considered to constitute a reservation, whether the retained interest arises under the express terms of the trust or it arises by operation of general law, e.g. a resulting trust.'

That is the settled practice of HMRC and is, perhaps, unlikely to be withdrawn at least in respect of policies settled before any announcement of a change. However, in the light of the House of Lord's decision in *R (oao Wilkinson) v CIR* [2006] STC 270, it is doubtful whether HMRC have the power to apply an incorrect view of the law to relieve a taxpayer of liability to tax. In *Garnett v Jones (Re Arctic Systems Ltd)* [2007] STC 1536, *CRC v Grace* [2009] STC 213 and *Genovese v CRC* [2009] SSCD 373, HMRC have shown a willingness to renege on their long standing practices in pursuit of an increased tax yield.

First decennial of the settlement

The tenth anniversary of the settlement will be an occasion of charge under s 64.

The amount charged is computed by applying a rate calculated under s 66 to the value of the relevant property in the settlement. The rate charged under s 66 is calculated by reference to a specified hypothetical chargeable transfer.

Section 66(3) provides that the chargeable transfer postulated is one of which the value transferred is equal to an amount determined in accordance with s 66(4) and which is made immediately before the ten-year anniversary concerned by a transferor who has in the preceding seven years made chargeable transfers of an aggregate value determined under sub-section (5). Section 66(5) provides that the aggregate includes the amounts on which any charges to tax have been imposed under s 65 in the ten years before the anniversary concerned.

As we have seen, on a strict reading, charges will arise under s 65 when the original policyholder becomes absolutely entitled to policies under the reversionary interest although HMRC's position appears to be that a charge will not arise in these circumstances. This in turn affects the calculation of the charge on the succeeding decennial which in turn will affect the calculation of exit charges under s 65 in the succeeding ten years.

The advance of the trust fund

The advance of the entire trust fund to the beneficiaries will be the occasion of an exit charge under s 65. That exit charge is calculated by reference to the rate of charge on the decennial preceding the exit event (see s 65(3) and s 69), so provided that rate is nil no inheritance tax will be charged on the advance. Because the rights arising under the policies advanced will not have been acquired by any person for actual consideration, any gain arising on the advance of the policies will not be a chargeable gain under TCGA 1992, s 210(2). Because the assignment of the policies to the beneficiaries by the trustees will not take place for consideration, the advance of the policies as part of the advance of the entire trust fund will not be a chargeable event (see ITTOIA 2005, s 484(1)(a)(ii)).

"The advance of the policies as part of the advance of the entire trust fund will not be a chargeable event."

Surrender of the remaining policies

The surrender of the policies after they have been advanced to the beneficiaries will not result in the diminution of their estates and therefore the surrender will not be a transfer of value. It will be a disposal for capital gains tax purposes, but any gains arising will not be chargeable gains by virtue of TCGA 1992, s 210(2). The surrender of the policies by the beneficiaries will be a chargeable event and if a chargeable event gain arises it will be assessable on the surrendering beneficiaries unless they are not resident in the UK in the year of surrender. (See ITTOIA 2005, s 465.)

Conclusion

I hope that this article will have helped to explain how a product such as this works with regards to the various parties involved and the potential tax implications at each stage. As we have seen, to some extent this is dependent on HMRC's interpretation of the legislation at various points. It may be unlikely that HMRC will resile from this construction at least in respect of any arrangements entered into before HMRC announce a change. It is always uncomfortable, however, to rely on HMRC continuing to apply such an over-generous construction.

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