INHERITANCE TAX PLANNING - TRUSTS, INSURANCE AND ALTERNATIVES:

AN ANALYSIS OF INSURANCE POLICIES USED IN ADVANCED INHERITANCE TAX PLANNING

Part II

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THE IOMA GROUP "ESTATE CONTROL BOND"

THE ARRANGEMENT

Introduction

1.1 The Isle of Man Assurance Limited ("IOMA"), an insurance company incorporated and resident in the Isle of Man, offers an arrangement (the "Arrangement") in respect of what it calls an "Estate Control Bond" (the "Bond"). The Bond is a group of term assurance policies (the "Polices") which are issued to a policyholder (the "Original Policyholder") who then assigns (the "Assignment") the Policies on trusts in a standard form.

Information Supplied

1.2 IOMA has been very helpful in providing a package of information (the "Information Pack") concerning the Bond. This includes Counsel's Opinion on the Arrangement, a Key Facts document, a summary of the Arrangement's Aims and Features, a comparison with a typical discounted gift trust, a technical brief including copies of relevant correspondence with HMRC (and its predecessor department, the Inland Revenue), a brochure giving information about IOMA and copies of the documentation which a client would complete on entering into the arrangement, including the standard trust deeds, completed in respect of a typical hypothetical client.

1.3 It has also very helpfully provided additional information including further copies of relevant correspondence with HMRC and the Inland Revenue and the instructions to Counsel in respect of the Arrangements.

The Policies

The Benefits

1.4 The Policies are fairly straightforward endowment policies conferring rights to benefits on the surrender, at any time, of the whole Policy (the "Full Surrender Benefit") on the partial surrender of the Policy after the death of the Original Policyholder (the "Partial Surrender Benefit"),[1] on the maturity of the Policy on a fixed date (the "Maturity Date") (the "Maturity Benefit") and on the death of the last of the lives assured (the "Death Benefit").

The Extension Right

1.5 The Maturity Date may be postponed but not accelerated at the option of the policyholder from time to time (the "Extension Right").

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[1] The Full Surrender Benefit and the Partial Surrender Benefit are referred to in this lecture together as the "Surrender Benefits" and the rights to these benefits as the "Surrender Rights"

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Other Characteristics

1.6 Each Bond may consist of up to one hundred Policies subject to each Policy having a minimum value on issue of £2,000. In the normal way for such policies, the policy benefits are calculated by reference to a collection of assets owned by the insurance company, the initial value of which is determined by the amount paid as a premium under the Policy.

1.7 It can be seen from this description that the Policies are conventional single premium endowment policies, the only slightly unusual feature being that the Policies may not be partially surrendered during the Original Policyholder's lifetime.

Staggered Maturity Dates

1.8 On entering into the Arrangement, a set of Policies is specified with Maturity Dates designed to supply cash at times when the Original Policyholder requires it. In our example[2] Mr Fillbarrell, wishing to simulate an annual income, enters into a bond consisting of one hundred Policies with maturity dates chosen so that five Policies mature in each of the next twenty years.

The Settlement

1.9 It is the settlement on trust which is the heart of the design of the arrangements and which is in a rather unusual form. The insurance company provides three alternative versions of the settlement according to whether the main beneficiaries are to be the Original Policyholder's children, his grandchildren or some other person. We shall examine the children's settlement (the "Settlement") which is the form most commonly used. The Information Pack assumes that all of the Policies will be settled. A technical brief in the Information Pack explains:-

> "Once established, the policies are gifted, by the owner, into an interest-in-possession trust for the benefit of his chosen beneficiaries. This is a Chargeable Transfer. However, the settlor **does not gift** the maturity benefits of each policy – these are retained for his benefit alone. Any policies that do mature will do so via a resulting trust …"

1.10 Although, as we shall see, this is loosely true,[3] it is achieved by a rather unusual route for the entire rights under the policies are assigned to the trustees.

The Trusts of the Settlement

1.11 The trusts on which the policies are held are described in the following paragraphs.

---

[2] See para 4.2.2 below

[3] The Settlor's retained interest in the policies is not a resulting trust but a contingent reversionary interest under the Settlement itself (see para 4.1.18 below)

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The Clause 3(a) Power

1.12 First clause 3(a) gives the trustees a wide power (the "Clause 3(a) Power") to declare by deed, during the Trust Period, trusts for the benefit of all or any one or more of the appointed class (the "Appointed Class"). The Appointed Class means:-

(i) The children and remoter descendants of the settlor (that is, the Original Policyholder);

(ii) The spouses, widows, widowers and civil partners and surviving civil partners of the persons in (i);

(iii) Such other person or persons as may be added to the Appointed Class before the Perpetuity Day by the trustees. No "Excluded Person" or trust may be added to the appointed class. An Excluded Person is the settlor and any person who is for the time being the spouse or civil partner of the settlor.

1.13 The property to which the trusts declared under clause 3(a) apply is "each policy".

1.14 As we shall see[4] the definition of the Trust Period is one of the keys to the operation of the Arrangement.

The Clause 3(b) Powers

1.15 In default of an appointment under the Clause 3(a) Power, under clause (b) ibid the trustees have broad discretionary powers (the "Clause 3(b) Powers") over capital to transfer or apply the capital to or for the benefit of all or any one or more of the Appointed Class. This power is exercisable during the Trust Period "in relation to each policy".

Clause 3 Powers cannot be exercised in favour of Excluded Persons

1.16 No power under Clause 3 may be exercised "so as to benefit any Excluded Person directly or indirectly."

The Clause 4 Trusts

1.17 Subject to, and in default of, 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" who are living on the "Relevant Date" in equal shares absolutely (the "Clause 4 Trusts"). The Beneficiaries are the children of the settlor (that is, the Original Policyholder) living at the date the Settlement is made. There are then provisions for the children of a deceased Beneficiary to take his interest per stirpes. The trusts contained in Clause 4 are to carry the intermediate income. The effect of this, and of further modifications made to the application of Trustee Act 1925 s.31 is that unless and until the trustees exercise their powers under Clause 3, where the Clause 4 Trusts apply the

[4] See paras 4.1.19 – 4.1.28 below

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Beneficiaries will have equal interests in possession in the settled property during the Trust Period.

The Reversionary Interest

1.18 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"). The Trust Fund means the "Policies" and in turn the Policies means the Policies assigned on the trusts of the settlement "and any Substituted Policies together with their full benefit and all moneys payable under them and the property representing or accruing to them or any monies payable under it …"

The Trust Period, Relevant Event and Relevant Date

1.19 The key concepts for understanding the trusts of the settlement are the definitions of the "Trust Period," the "Relevant Date" and the "Relevant Event" and the fact that these terms, the powers in Clause 3 and the trusts declared in Clause 4 operate by reference to individual policies.

The Relevant Event

1.20 The "Relevant Event" in relation to each policy means the death of the settlor (the Original Policyholder) before the Maturity Date.

The Relevant Date

1.21 The "Relevant Date" in relation to each policy means the date when the Relevant Event occurs.

The Trust Period

1.22 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) The Perpetuity Day (that is, eighty years after the making of the settlement);

(b) The last survivor of the beneficiaries and their descendants dying before the Relevant Event has occurred;

(c) The Relevant Event ceasing to be capable of occurring without actually having occurred.

If the Original Policyholder lives to the Maturity Date

1.23 It is the last of these which is significant. 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 that Policy will end.

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1.24 Thus, if the Original Policyholder is alive at the Maturity Date of the Policy the Clause 4 Trusts will not apply because they only apply during the Trust Period and the Clause 3(b) Power will lapse because that power only operates during the Trust Period. The result is that if the trustees have not exercised their Clause 3(a) Power, which may also only be exercised during the Trust Period, the settlor will become absolutely entitled to the trust fund under the Reversionary Trusts. Because the Clause 3 Powers and the Clause 4 Trusts operate in respect of each Policy, the Trust Period in respect of that Policy will determine at the point at which the right to a Maturity Benefit under that Policy arises with the result that the Original Policyholder would then be absolutely entitled to that Maturity Benefit.

If the Original Policyholder dies before the Maturity Date

1.25 If, however, the Original Policyholder dies before the Maturity Date the result will be that 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 the Perpetuity Period. In most circumstances, therefore, if the Original Policyholder dies before the Maturity Date of a policy the Trust Period in respect of that policy will be eighty years from the settlement date.

Exercising the Extension Right

1.26 If the trustees exercise the Extension Right under a Policy the effect, in respect of that Policy, is to lengthen the Trust Period and therefore to make it more likely that the settlor will die before the Maturity Benefit becomes payable.

1.27 The effect of exercising the Extension Right will be to postpone the point at which the investment in the Policy is transformed into a right to a payment. This is an important investment consequence. It may also have the effect of varying the beneficial interests in the trust property. In exercising their powers trustees are under a duty to balance the interests of the beneficiaries[5] and a duty, in respect of the investment of the trust property, to exercise such care and skill as is reasonable in the circumstances.[6] The trustees of the settlement may have a difficult task in reconciling their duty in respect of their power of investment with their duty to balance the interests of the trust beneficiaries[7] (who will include the settlor by virtue of the reversionary interest) because of the effect that an exercise of the Extension Right may have on the beneficial interests of those beneficiaries.

1.28 The material supplied to us does not indicate that the insurance company has taken Counsel's opinion specifically in relation to the trust law issues raised by the arrangement although the trust documentation has been drafted by its solicitors, Lawrence Graham LLP and submitted, with the Instructions, to Counsel.

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[5] *Howe v Earl of Dartmouth* (1802) 7 Ves.137

[6] Trustee Act 2000 s.1

[7] The trust beneficiaries being a wider class than the 'Beneficiaries' as defined in the Settlement. They will include all actual and potential members of the Appointed Class and also, by reason of his contingent reversionary interest, the Original Policyholder

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The Trustees

1.29 According to the "Technical Observations And Trust Aide Memoire" which is included in the Information Pack "the Settlor [the Original Policyholder] should not be included as a trustee." It is not clear why this should be so. Of course, if the Original Policyholder were to be a trustee he would have to be careful to exercise his trusteeship with regard to his duty to all of the beneficiaries and not in his own interest. It is common, however, for trustees to include persons who are also both settlors and beneficiaries of the settlement concerned. In our opinion, because the trustees' powers, the exercise of which is subject to the jurisdiction of the Court, are fiduciary in nature. for a settlor/beneficiary to act as trustee should have no relevance to such questions as, for example, whether there is a gift with reservation[8] or whether FA 2004 Sch 15 para 8 applies to the Settlement.[9]

The Lives Assured

1.30 Under the Life Assurance Act 1774 s.I a policy of life assurance is void if the person entering into the policy does not have an insurable interest in the life of the life assured at that time. Being a creature of statute, however, this requirement for an insurable interest is not fundamental to the nature of life insurance and it is not part of the insurance law of many other jurisdictions, including the Isle of Man. In such jurisdictions life insurance policies may be written on the lives of any natural person. In order to create policies which are highly unlikely to determine on death so that, in practice, the determination of the Policies can be controlled by the policyholder (who after the Assignment will be the trustees) through the exercise of the Extension and Surrender Rights, the Policies under the Arrangements are written on multiple lives. In the example given in the Information Pack they are written on the lives of the two sons, the daughter and the two grandchildren of the Original Policyholder and in the Example they are written on the lives of Mr Fillbarrell's children, grandchildren, nephews and nieces.

AN EXAMPLE

2.1 In order to analyse the application of Inheritance Tax, Capital Gains Tax and Income Tax to the Arrangement we consider the application of these taxes to the transactions taking place in the following Example.

Example

2.2

Mr Fillbarrell has made no previous transfers of value. He was seventy years old on 31st March 2009 and has two children to whom he will leave his estate on death. Mr Fillbarrell and his children are, and have been at all times, resident and ordinarily resident in the United Kingdom and domiciled in England.

[8] See paras 4.7.1 – 4.7.9 below
[9] See paras 4.4.15 – 4.4.31 below

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The Issue of the Policies

On the 30th April 2009 he takes out an Estate Control Bond with IOMA paying premia with an aggregate value of £331,000 in respect of one hundred Policies written on the lives of his children, grandchildren, nephews and nieces.

The Assignment on the Trusts of the Settlement

On the 1st May 2009 he assigns the Policies to his solicitors, Yarlington Mill LLP, to hold on Trust. For this purpose he uses the proforma children's settlement supplied by IOMA. Maturity dates for the Policies are specified so that five Policies will mature in each of the next twenty years.

The First Exercise of the Extension Rights in respect of Policies 1 to 30

In each of the first six years, 2010 to 2015 and shortly before the 30th April in each year, Mr Fillbarrel informs the trustees that he does not need the reversions due to fall in those years and the trustees exercise the Extension Rights to defer the Maturity Dates of Policies 1 to 30 until 30th April 2020.

The Vesting of the Reversions in respect of Policies 31 to 45

In the succeeding three years the Maturity Dates are not extended and Mr Filbarrel receives the following Maturity Benefits:-

DATE	POLICY NUMBERS	AMOUNT
30th April 2016	31-35	23,288
30th April 2017	36-40	24,452
30th April 2018	41-45	25,674

The Death of the Original Policyholder

On the 30th June 2018 Mr Fillbarrel dies having made no further transfers of value after the Assignment.

The Advance of Policies 51 to 55 followed by their surrender

On the 31st March 2019 the trustees advance five Policies (numbers 51 to 55) to the Beneficiaries who surrender them and receive £26,852.

The Maturity of Policies 46 to 50

On the 30th April 2019 Policies 46 to 50 mature and the trustees receive £26,958 a few days later.

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The First Decennial of the Settlement

On the 1st May 2019 the trust assets and their value were:-

	£
Right to Maturity Benefit in respect of Policies 46-50	26,958
Policies 1-30 and 56-100	377,412
	404,370

The Nil-Rate Band on the 1st May 2019 is £505,000.

The Surrender of Policies 1 to 5

On the 31st October 2019 the trustees surrender Policies 1 to 5 and receive Full Surrender Benefits of £27,632.

The second exercise of the Extension Right in respect of Policies 6 to 30

On the 29th April 2020 the trustees exercise their Extension Rights in respect of Policies 6 to 30 for the second time.

The Advance of the Entire Remaining Trust Fund

On the 6th April 2021 the trustees advance the assets of the trust including the remaining Policies to the Beneficiaries, both of whom were now neither resident nor ordinarily resident in the United Kingdom in the fiscal year 2021/2022.

The Surrender of the Remaining Policies by the Beneficiaries

The beneficiaries immediately surrender the remaining policies receiving proceeds of £386,000.

THE ISSUE OF THE POLICIES

Inheritance Tax

A transfer of value?

3.1 When the Policies are issued to the Original Policyholder he will make a disposition. That disposition will be a transfer of value if it results in a decrease in the value of his estate.[10] In order to determine whether there has been such a decrease one must value the transferor's estate immediately before and immediately after the disposition is made. Before the disposition the Original Policyholder's estate will include the money which

[10] Section 3(1). All statutory references in this lecture are to the Inheritance Tax Act 1984 unless otherwise stated

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he is about to pay by way of premia. After the disposition he will own beneficially all of the rights under the Policies. So if the market value[11] of the policies is less than the amount of the premia there will be a transfer of value. As the policies are in all but one respect in the same form as standard policies which are taken out by persons simply as investments it may be that there will be no significant difference between the two amounts. The one way in which the Policies differ from conventional endowment policies is that there cannot be a partial surrender during the lifetime of the Original Policyholder. As the Bond is divided into up to one hundred Policies it will be easy to realise a part only of the Original Policyholder's investment by surrendering some but not all of the Policies. The restriction of the Partial Surrender Right is, therefore, unlikely to have any significant effect on the market value of the Policies.

Is it an exempt transfer?

3.2 If the issue of the Policies is a transfer of value it will not be a potentially exempt transfer because, although it is made by an individual, it is not a gift to an individual or to a privileged trust.[12] Indeed, it is not a gift at all. It will be a chargeable transfer unless it is exempt under any provision.[13] Will it be exempt under IHTA 1984 s.10? Sub-section 1 of that section provides that:-

> "(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either -
>
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
>
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other."

3.3 For this purpose a 'transaction' includes a series of transactions and any associated operations.[14] It seems clear that the making of the contract and the assignment of the contract to the trustees on the trusts of the settlement are a series of transactions (and they are also, of course, associated operations) and, therefore, that the transaction to be considered for the purpose of applying s.10(1) is a composite transaction which includes the issue of the Policies and their assignment to the trustees.

3.4 That being the case, it is difficult to see how the disposition consisting of the making of the Policies can satisfy the condition that it "… was not made in a transaction intended to confer any gratuitous benefit on any person."

[11] Section 167 (see below) will not apply because the policies will not cease to be part of the settlor's estate by virtue of the disposition (see sub-section (2)(b) ibid)
[12] Section 3A(1A)
[13] Section 2
[14] Section 10

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3.5 As we have said, however, if the issue of the Policies is a transfer of value it is likely to be of only a minimal amount.

Capital Gains Tax and Income Tax

3.6 There will be no Capital Gains Tax or Income Tax chargeable on the issue of the Policies.

THE ASSIGNMENT ON THE TRUSTS OF THE SETTLEMENT

Inheritance Tax

4.1 The assignment of the Policies on the trusts of the Settlement is also a disposition which will be a transfer of value because it results in a decrease in the value of the estate of the Original Policyholder.

4.2 Before the transfer the Original Policyholder's estate will contain the Policies. The Original Policyholder's estate after the transfer will contain the Reversionary Interest. A reversionary interest is not excluded property if it is one to which the settlor is or has been beneficially entitled.[15] The measure of the transfer of value arising by reason of the Assignment on the trusts of the Settlement is to be found by deducting the market value of the Reversionary Interests from the market value of the Policies.

The Market Value of the Policies

4.3 Under s.167 the value of the Policies is to be taken to be not less than the total of the premia or other consideration which at any time before the transfer of value has been paid under the Policies. Therefore the value of the Policies immediately before the Assignment is to be taken to be the higher of their actual market value and the premia paid in respect of them.

The Market Value of the Reversionary Interest

4.4 In Counsel's Opinion it is stated:-

> "Nor will there be any discount by reference to the reversions retained by the Settlor, since those can be defeated by the exercise of powers conferred on the Trustees. What is retained by the Settlor does not, therefore, have a market value which is capable of reducing the amount of the transfer of value by the Settlor. The transfer of value, less any available annual exemption, will, in my opinion, be an immediate chargeable transfer, not a potentially exempt transfer ("PET") within section 3A of IHTA 1984 (as amended by FA 2006).
>
> Working out the amount of the immediate chargeable transfer at the outset is therefore a very easy matter. It is just the gross amount invested by Settlor into the bond, less any available annual exemption. That is fortunate, because the

[15] Section 48(1)

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actual amount of the initial chargeable transfer is critical in working out whether any IHT has to be paid at the outset."

4.5 Matters are not quite as simple as this, although the practical effect is little different from that set out in the Opinion.

4.6 Where a beneficial interest is assigned and notice of the assignment is given to the trustees, the trustees must give effect to the acquirer's beneficial interest. The acquirer, therefore, becomes a trust beneficiary.[16] Thus the trustees' duty to balance the interests of the members of the appointed class and of the remainder-man will continue in respect of the new remainder-man. If the trustees were simply to use their powers by reference to the interests of the Appointed Class without considering the interests of the remainder-man they would act in breach of trust. So the purchaser of the Original Policyholder's Reversionary Interest would at least be able to enforce the trustees' duty to balance his interests against those of the Appointed Class in deciding whether or not to exercise the Extension Right. So the Original Policyholder's Reversionary Interests might have some speculative value. It is true, however, that any such value is likely to be a small percentage of the likely Maturity Benefit because a purchaser would take account of the fact that the outcome of attempting to challenge the trustees' use of the Extension Right would be very uncertain.

The Amount of the Transfer of Value

4.7 Because of the application of s.167 and because, as we have concluded, the market value of the Reversionary Interest will be low, the transfer of value will be equal to or near to the higher of the market value of the policies at the time of the assignment and the premia paid in respect of the policies before the assignment. As we have said, the market value of the policies is likely to be near to the amount of the premia paid but to the extent that the market value is less than the premia paid there is the potential for a double charge here. That is because, as we have seen,[17] on the issue of the policies there is a chargeable transfer equal to any excess of the premium paid over the market value of the policies on issue whereas the potentially exempt transfer on the Assignment on the trusts of the Settlement cannot be less than the premium paid less the, probably minimal, value of the Reversionary Interest. In practice, however, because there may be no difference between the premia paid and the market value of the Policies on issue and, if there is a difference it is likely to be small, any double charge is likely to be insignificant.

Is the Assignment a Chargeable Transfer?

4.8 So the assignment on the trusts of the Settlement is a transfer of value. It will be an immediately chargeable transfer unless it is an exempt transfer (which it clearly is not) or a potentially exempt transfer.[18] It is not a potentially exempt transfer because it is not a gift to another individual or into a disabled trust or into a bereaved minor's trust.[19]

[16] *Re Common* (1889) 39 ChD 443 and *Re Smith* [1928] Ch 915
[17] See para 4.3.1 above
[18] Section 2
[19] Section 3A(1A)-(c)(i)-(iii)

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The Charge on the Assignment

4.9 As the Company's promotional material makes clear, 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 which do not exceed the Original Policyholder's unutilised Nil-Rate Band.

Prior Potentially Exempt Transfers

4.10 There is also a potential trap which applies, as the Promotional Material explains, to this Arrangement as to any other Relevant Property Settlement. If the settlor has made a potentially exempt transfer before making the settlement and dies within seven years of making the potentially exempt transfer, that transfer will be chargeable. That would use up some part of the available Nil-Rate Band with the result that the chargeable transfer arising on the making of the settlement might itself bear Inheritance Tax with a further effect on the rate of tax arising on future decennial[20] and exit charges.[21]

4.11 In our example Mr Fillbarrel has made no previous transfers of value. If we assume that the market value of the Policies immediately after the Policies are issued and on their assignment are equal to the premium paid he makes a transfer of value of £331,000. His annual exemptions[22] for 2008/2009 and 2009/2010 are unused so the entire transfer is either exempt or within his unutilised Nil-Rate Band.

	£	£
Transfer of value		331,000
Annual exemptions		
2008/2009	3,000	
2009/2010	3,000	
		<6,000>
Chargeable transfer		325,000
Chargeable at 0%		325,000
Chargeable at 20%		0

20 See para 4.10.5 below
21 See para 4.5.3 below
22 Section 19

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	325,000
Tax chargeable	NIL

Capital Gains Tax

4.12 TCGA 1992 s.210 provides:-

> "(1) This section has effect in relation to any policy of insurance or contract for a deferred annuity on the life of any person.
>
> (2) A gain accruing on a disposal of, or of an interest in, the rights conferred by the policy of insurance or contract for a deferred annuity is not a chargeable gain unless subsection (3) below applies.
>
> (3) This subsection applies if -
>
> (a) (in the case of a disposal of the rights) the rights or any interest in the rights, or
>
> (b) (in the case of a disposal of an interest in the rights) the rights, the interest or any interest from which the interest directly or indirectly derives (in whole or in part),
>
> have or has at any time been acquired by any person for actual consideration (as opposed to consideration deemed to be given by any enactment relating to the taxation of chargeable gains).
>
> (4) For the purposes of subsection (3) above -
>
> (a) (in the case of a policy of insurance) amounts paid under the policy by way of premiums, and
>
> (b) (in the case of a contract for a deferred annuity) amounts paid under the contract, whether by way of premiums or as lump sum consideration,
>
> do not constitute actual consideration."

4.13 An assignment of the policy for no consideration does not give rise to the chargeable gain and cannot result in an allowable loss.[23]

[23] TCGA 1992 s.16

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Income Tax

Is there a Chargeable Event?

4.14 A life insurance policy, except, perhaps, a short life term policy, is a capital asset. The excess of benefits paid under the policy over the premia paid is a capital profit. Provisions now rewritten in ITTOIA 2005, Part IV, Chapter IX, however, provide for a charge to Income Tax to arise on gains "treated as arising on policies and contracts to which this chapter applies."[24] A gain on a policy may arise when a chargeable event occurs in relation to the policy or contract.[25] 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 moneys worth.[26] The Assignment on the trusts of the Settlement is not for money or moneys worth and therefore is not a chargeable event.

The Pre-Owned Assets Charge

4.15 In an attempt to deter and punish various Inheritance Tax avoidance structures, FA 2004 s.84 and Sch 15 imposed the Pre-Owned Assets Charge to Income Tax. Schedule 15 and paragraphs 8 & 9 provide that:-

> **"8 -**
>
> (1) This paragraph applies where -
>
> (a) 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 virtue of section 624 of ITTOIA 2005 (income arising under settlement where settlor retains an interest) as income of a person ("the chargeable person") who is for the purposes of Chapter 5 of Part 5 of that Act the settlor,
>
> (b) any such income would be so treated even if s.625(1) of ITTOIA 2005 did not include any reference to the spouse of the settlor, and
>
> (c) that property includes any property as respects which the condition in sub-paragraph (2) is met ("the relevant property").
>
> (2) The condition mentioned in sub-paragraph (1)(c) is that the property is intangible property which is or represents property which the chargeable person settled, or added to the settlement, after 17th March 1986.
>
> (3) Where this paragraph applies in respect of the whole or part of a year of assessment, an amount equal to the chargeable amount determined under paragraph 9 is to be treated as income of the chargeable person chargeable to income tax.

---

[24] ITTOIA 2005 s.461(1)
[25] Section 462(1) ibid
[26] ITTOIA 2005 s.484(1)(a)(ii)

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9 -

(1) For any taxable period the chargeable amount in relation to the relevant property is N minus T where -

N is the amount of the interest that would be payable for the taxable period if interest were payable at the prescribed rate on an amount equal to the value of the relevant property at the valuation date, and

T is the amount of any income tax or capital gains tax payable by the chargeable person in respect of the taxable period by virtue of any of the following provisions -

(a) section 461 of ITTOIA 2005,

(b) section 624 of that Act,

(c) section 720-730 of the Income Tax Act 2007,

(d) section 77 of the Taxation of Chargeable Gains Act 1992 (c. 12), and

(e) section 86 of that Act,

so far as the tax is attributable to the relevant property.

(2) Regulations may, in relation to any valuation date, provide for a valuation of the relevant property by reference to an earlier valuation date to apply subject to any prescribed adjustments.

(3) In this paragraph -

"the taxable period" means the year of assessment, or part of a year of assessment, during which paragraph 8 applies to the chargeable person;

"the valuation date", in relation to a year of assessment, means such date as may be prescribed."

4.16 Although the charge applies where the Income Tax provisions of ITTOIA 2005 s.624 would apply if there were any income arising from the property comprised in the settlement, "settlement" and "settled property" have the same meaning as in IHTA 1984.

4.17 The definition of "settlement" for Inheritance Tax purposes is given by s.43:-

"(1) The following provisions of this section apply for determining what is to be taken for the purposes of this Act to be a settlement, and what property is, accordingly, referred to as property comprised in a settlement or as settled property.

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(2) "Settlement" means any disposition or dispositions of property, whether effected by instrument, by parol or by operation of law, or partly in one way and partly in another, whereby the property is for the time being –

(a) held in trust for persons in succession or for any person subject to a contingency, or

(b) held by trustees on trust to accumulate the whole or part of any income of the property or with power to make payments out of that income at the discretion of the trustees or some other person, with or without power to accumulate surplus income, or

(c) charged or burdened (otherwise than for full consideration in money or money's worth paid for his own use or benefit to the person making the disposition) with the payment of any annuity or other periodical payment payable for a life or any other limited or terminable period,

or would be so held or charged or burdened if the disposition or dispositions were regulated by the law of any part of the United Kingdom; or whereby, under the law of any other country, the administration of the property is for the time being governed by provisions equivalent in effect to those which would apply if the property were so held, charged or burdened."

4.18 It is clear that this section looks at the property which is subjected to the 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 purpose 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. It is perfectly 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). At the point at which a Policy is assigned on the trusts of the Settlement, therefore, it is clearly held for persons in succession and is subject to a contingency and therefore the whole Policy is 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. During the period when it is settled property, if that property were to give rise to income that income would be treated as income of the Original Policyholder by virtue of ITTOIA 2005 s.624 which applies, inter alia, where the settled property "will, or may, become payable to the settlor or the settlor's spouse."[27] The settled property, consisting of the Policy, is property which is intangible property and which the Original Policyholder settled.[28] "Intangible property"

[27] ITTOIA 2005 s.625(1)
[28] Finance Act 2004 Sch 15, para 8(2)

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for this purpose is any property other than chattels or an interest in land and so the Policies are clearly intangible property.

4.19 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.

4.20 Finance Act 2004 Sch 15 para 13(3) & (5) provides that paragraph 8 is not to apply at any time when the settled property by reference to which paragraph 8 would otherwise apply "would fall to be treated by virtue of any provision of [the gifts with reservation rules in FA 1986] as property which in relation to him is property subject to a reservation."

4.21 So, in our opinion although immediately after the assignment, the Arrangement will fall within FA 2004 Sch 15 para 8 it will be exempted from the Pre-Owned Assets Charge because the property in the settlement is property subject to a reservation.[29]

4.22 As we shall see, however, in HMRC's view the assignment is not a gift with reservation.[30] If that view were correct, the Pre-Owned Assets Charge would apply.

4.23 Counsel's Opinion does not comment on whether the Pre-Owned Assets Charge will apply because, subject to two specific points raised in the instructions, Counsel was not "instructed to advise on taxes other than IHT and [he does] not do so."[31]

4.24 In September 2004 correspondence between HMRC and the Association of British Insurers was published in which HMRC said:-

> "You were concerned that where trustees hold a policy of assurance, under the terms of which certain benefits have been retained by the settlor/proposer whilst the remaining benefits inure for others, the current provisions of para 8 are such that an income tax charge would be imposed on the settlor. This concern was based on the premise that the property comprised in the settlement is an indivisible *chose in action*, being the contract with the insurance company held by the trustees. You asked that we set out our views on why that approach to this draft legislation is in our eyes misconceived; these are as follows.
>
> "Settlement" and "settled property" for the purposes of Sch 15 mean the same as in IHTA 1984; see ss 43(1) and (2) of that Act.
>
> There are two relationships in being. The first is that between the company and the trustees, and is purely contractual. So far as the company is concerned that gives rise to an indivisible chose in action to which the company is one party. That is of no relevance to the current income tax/IHT issues. The material

[29] See paras 4.7.1 – 4.7.9 below
[30] See paras 4.7.5 – 4.7.9 below
[31] At para 39 of Counsel's Opinion

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relationship is that between the trustees and the beneficiaries. The trustees possess the legal interest in the chose in action. They hold certain interests in the *chose* on the terms of a trust that falls into the IHTA 1984 s.43(2) definition of settlement for the benefit of persons other than the settlor. Those are the interests which are the property comprised in the settlement within the meaning of paragraph 8. Other interests, those retained by the settlor, are held by the trustees on a bare trust for him. A bare trust is not within the definition of settlement at all, and property so held cannot come within the ambit of para 8.

So in the simple case where the settlor has retained a right to an annual income under arrangements which are not subject to the "gifts with reservation" (GWR) legislation, that right which is enforceable against the trustees is not property within para 8, being a bare trust. If the company is not providing the income to the trustees for them to pass on, then that would give rise to an action by the trustees against the company under the *chose in action* they hold.

There may be more complex cases where the settlor's retained rights or interests are themselves held on trust. But that would normally be construed as being a freestanding trust of those benefits in which the settlor had an interest in possession, which would fall within the exemption in para 11.

In the straightforward case where the settlor has retained a right to an annual income subject to a reversion under arrangements which are not subject to the GWR legislation, that right is not property within para 8 as the trustees hold it on bare trust for the settlor. The settlor is excluded from other benefits under the policy and so Sch 15 has no application.

Even if the para 11 provisions did not apply so as to exempt the case from charge completely, any Sch 15 charge would apply by reference to the value of the rights held on trust for the settlor, not by reference to the value of the underlying life policy."

4.25 Although at first sight this statement may appear helpful it really is not. The Arrangement does not make separate trusts of the Surrender and Death Benefits for the Appointed Class and of the Maturity Benefits for the Original Policyholder.

4.26 HMRC's approach in this correspondence, however, is to regard the 'property' referred to in FA 2004 Sch 15 para 8 not as being the property over which the trusts are declared but rather the interests in that property which arise under the trusts. The technical brief in the Information Pack follows this approach stating:-

> "The logic of carved out reversions being **deemed to be held in a 'bare trust' for the settlor and thereby not forming part of any gifted property** ties in quite properly, in my view, with HMRC/Inland Revenue treatment of reversions under the Pre-Owned Assets Tax regime, as confirmed by Mr Peter Twiddy in his letter to Neil Greenslade dated 3rd August 2004."

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4.27 IOMA have very helpfully made the full text of that letter available to us. The letter states:-

> "**Schedule 15 Finance Act 2004**
>
> The following general statement is subject to the law remaining as it currently stands, and to consideration of the full facts and documents in each case.
>
> Where a settlor settles intangible property in his outright legal and beneficial ownership into a settlement under which the trustees hold interests in that intangible property upon trust for certain beneficiaries other than the settlor for a period or subject to a contingency, with or without power for the trustees to confer further interests or eligibility to benefit on those or other beneficiaries (but not the settlor), and subject to those trusts (and powers if any) the remaining interests in that intangible property is held in trust for the settlor absolutely, then, notwithstanding the reference to section 660A ICTA 1988 [now s.624 ITTOIA 2005] in paragraph 8 of Schedule 15 –
>
> (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. In other words there is either a settlement for the beneficiaries and a bare trust for the settlor, or a further separate settlement which contains the settlor's interest;
> (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 paragraph 11(1) Schedule 15. There would therefore be total freedom from the POAT charge."

4.28 Although Mr Twiddy caveats his comments as being subject to "consideration of the full facts and documents in each case" the situation which he summarises in the second paragraph of his letter closely matches the trusts under the Arrangement and so we may assume that the Inland Revenue (as it then was) accepted that the analysis which follows in Mr Twiddy's letter would apply to the Arrangement.

4.29 It has to be said, however, that the letter's statement that "intangible property which forms the trust fund of the settlement is not itself 'the property' or 'the relevant property' referred to in paragraph 8" is simply incorrect. First, an interest arising under the settlement clearly cannot be property comprised in that settlement. There is a distinction between the property which is subjected to the trusts of the settlement and the interests arising under those trusts. Secondly, this construction of paragraph 8 is simply inconsistent with the operation of ITTOIA 2005 s.624. It has been accepted for many years, and is clearly the case, that where for example a settlor settles property on life interest trusts for his grandchild with a reversion to himself, s.624 applies to the income

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arising to the grandson because it is income which arises under the settlement from property in which the settlor has an interest. If the property were the interest in possession rather than the property in which the interest in possession subsists, that condition would not be satisfied.

4.30 IOMA have very naturally relied on the apparently unequivocal nature of Mr Twiddy's letter. Mr Twiddy's construction, however, is quite untenable. The Clause 3 Powers and the trusts of Clause 4 are expressed to apply in respect of a whole policy.[32] The trusts of the Reversionary Interest apply to the whole Trust Fund.[33] The Assignment does not create a bare trust in the property. It creates interests in succession subject to a contingency.

4.31 This is a generic problem for all insurance companies attempting to create Inheritance Tax planning products which arises from the very low quality of the legislation which the Government has produced in the last few years. HMRC do not wish to cripple the insurance industry and have attempted to deal with the problem by adopting over generous interpretations of the law. That leaves the taxpayer in the very uncertain position of relying on Inland Revenue and HMRC statements which are irreconcilable with the law. If HMRC were to resile from its published view in respect of a particular implementation of the Arrangement the taxpayer concerned would have to rely on the uncertain remedy of judicial review on the ground of defeat of legitimate expectation.

THE EXERCISE OF THE EXTENSION RIGHTS IN RESPECT OF POLICIES 1 TO 30

Inheritance Tax

Is the exercise of the Extension Right a chargeable transfer?

5.1 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.[34]

5.2 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.[35]

Does an exit charge occur under Section 65?

5.3 The Settlement is a relevant property settlement within Chapter 3 of Part 3. Is there an exit charge under s.65? There will be an exercise charge:-

> "(a) where the property comprised in a settlement or any part of that property ceases to be relevant property (whether because it ceases to be comprised in the settlement or otherwise); and

[32] See paras 4.1.12 – 4.1.17 above

[33] See para 4.1.18 above

[34] Section 3

[35] Section 2

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(b) in a case in which paragraph (*a*) above does not apply, where the trustees of the settlement make a disposition as a result of which the value of relevant property comprised in the settlement is less than it would be but for the disposition."

5.4 FA 1986 s.102ZA treats an individual as disposing, by way of gift, of property in which he has an interest in possession where the interest in possession comes to an end. Section 102ZA cannot apply to the exercise of the Extension Right by the trustees because, inter alia, that exercise does not bring the Beneficiaries' interest in possession to an end and, in any event, the interest in possession is not one to which s.102ZA applies.

5.5 It is clear that property comprised in the Settlement (the Policy) does not cease to be relevant property by reason of the exercise of the Extension Right[36] but is the value of the Policies (the relevant property comprised in the Settlement), less than it would be but for the disposition? It is the Policy, and not the Maturity Benefit, which has to be valued. The effect of deferring the Maturity Date is that the Maturity Benefit is deferred. The value of the Policy may be realised by surrender in full at any time. So the value of the Policy to a purchaser would be uneffected by the deferral of the Maturity Date.

5.6 Even if HMRC were right in saying that the property in the settlement consists of the interests arising under the settlement rather than the property in which those interests subsist[37] and that the Reversionary Interest is not settled property, the effect of the exercise of the Extension Right would be to increase the value of the settled property. Even under HMRC's erroneous view, therefore, there would be no exit charge under s.65 by virtue of the exercise.

Capital Gains Tax and Income Tax

5.7 No charges to Capital Gains Tax and Income Tax will arise by reason of the exercise of the Extension Rights.

THE VESTING OF REVERSIONS IN RESPECT OF POLICIES 31 TO 45

Inheritance Tax

Is there an Exit Charge under Section 65?

6.1 We have seen that s.65 imposes an 'exit charge' where the property comprised in the Settlement or any part of that property ceases to be relevant property (whether the property ceases to be comprised in the Settlement or otherwise). We have also said that it is clear that for the purposes of the Inheritance Tax definition of a settlement that an entire Policy is settled property. When the Reversionary Interest vests, the Original Policyholder will become absolutely entitled to that Policy (which, at that stage, will

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36 Section 58

37 See para 4.4.27 above and paras 4.7.5 – 4.7.9 below

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confer a right to the Maturity Benefit and no other right). The Policy will therefore no longer be settled property within the definition given in s.43 because it will no longer be held in trust for persons in succession or for any person subject to a contingency. Rather, the Original Policyholder will have a vested absolute interest in it. An exit charge will, therefore, arise.

HMRC's View

6.2 The Information Pack includes a letter from Mr McNicol of HMRC dated the 3rd August 2006 in which he says:-

> "In the sort of arrangements you have in mind, you have indicated that 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. On that basis, I can confirm that we would regard such a reversionary interest of a settlor as a bare trust for him or her and not as relevant property within the terms of Chapter III Part III Inheritance Tax Act 1984. Thus the reversionary interest would not attract the periodic or exit charges to which you refer."

6.3 In the context of the correspondence referred to it is fairly clear that HMRC's position is that when the Reversionary Interest vests and the settlor becomes absolutely entitled to the property in which it subsists there is no exit charge under s.65.

Counsel's View

6.4 Counsel's Opinion says:-

> "The rationale for this view appears to be that the distributions to the Settlor are derived not from the property that is settled into the Settlement, but are rather derived from the reversions which are carved out from the gift and retained by the Settlor. That HMRC takes this view, which takes the carve-out theory in connection with reservation of benefit into a new and rather unexpected area, is most welcome. There is, in effect, an exemption rather similar to that which applies under section 53(3) of IHTA 1984 in connection with interest in possession trusts made before 22 March 2006 (even though that exemption is not in point in connection with settlements that are within the "relevant property" regime). One might have expected that HMRC would have taken the view that the carve-out theory has no relevant application in the present context. The question is whether the Bond is itself settled property. If the Bond is itself settled property, then it is clearly relevant property. Property can itself be settled property even though the settlor retains an interest in it. On that approach, there would be no exemptions from the exit charge for reversions to the Settlor and the reversions would be taken into account in working out the rate of subsequent ten year charges. Happily, HMRC has clearly rejected this approach and taken the favourable view set out above, extending the carve out theory into a new area."

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An Exit Charge under Section 65

6.5 Counsel's Opinion accurately states the implications of the view expressed by HMRC but equally clearly that view is incorrect. Before the vesting, it is clear that 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.

Can one rely on HMRC's View?

6.6 Can one rely on HMRC's expression of their view that no such charge arises? There is, perhaps, an ambiguity in their letter. It is true that once the reversion has vested then it creates a bare trust in the Policy. So it may be that HMRC will in the future seek to escape from its statement by saying that the correspondence refers not to the moment at which the interest vests but to any dealings in the property thereafter. As we have said, in the context of the preceding correspondence it seems clear that that is not the point which HMRC are making and, indeed, the correspondence would have little point if it were. Nonetheless, the letter is not written with any great precision and it may allow room for HMRC to renege on its position.

6.7 In paragraphs 4.7.1 *ff* we consider whether the Policies assigned on the trusts of the Settlement are properties subject to a reservation within FA 1986 s.102(2).[38] We conclude that the policies are subject to a reservation although, on the basis of views published by the Inland Revenue, it appears that HMRC would consider that they are not.

A Double Charge?

6.8 Assuming that immediately before the end of the Trust Period the Policies are indeed property subject to a reservation, what is the effect of the Original Policyholder becoming absolutely entitled to the Policies under the Reversionary Interest?

6.9 It is not an occasion under which the Policy ceases to be property subject to a reservation within FA 1986 s.102(4) because after the reversion the property is not enjoyed "to the entire exclusion … of the donor." In fact the donor, the Original Policyholder, is the absolute beneficial owner of the Policy. One might worry, therefore, that on the settlor's later death there will be a double charge. The property would be deemed to form part of the Original Policyholder's estate because it is property subject to a reservation and, in addition, would actually form part of the Original Policyholder's estate. Actually, that is not the situation. FA 1986 s.102(3) provides that property which is subject to a reservation is to be treated as property to which the donor is beneficially entitled immediately before his death "to the extent that the property would not, apart from [FA 1986 s.102] form part of the donor's estate immediately before his death."

[38] See paras 4.7.1 *ff*

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THE DEATH OF THE ORIGINAL POLICYHOLDER

Inheritance Tax

Gifts with Reservation

7.1 Finance Act 1986 s.102 provides that:-

"(1) Subject to subsections (5) and (6) below, this section applies where, on or after 18th March 1986, an individual disposes of any property by way of gift and either-

(a) possession and enjoyment of the property is not bona fide assumed by the donee at or before the beginning of the relevant period; or

(b) at any time in the relevant period the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise;

and in this section "the relevant period" means a period ending on the date of the donor's death and beginning seven years before that date or, if it is later, on the date of the gift.

(2) If and so long as-

(a) possession and enjoyment of any property is not bona fide assumed as mentioned in subsection (1)(a) above, or

(b) any property is not enjoyed as mentioned in subsection (1)(b) above, the property is referred to (in relation to the gift and the donor) as property subject to a reservation.

(3) If, immediately before the death of the donor, there is any property which, in relation to him, is property subject to a reservation then, to the extent that the property would not, apart from this section, form part of the donor's estate immediately before his death, that property shall be treated for the purposes of the 1984 Act as property to which he was beneficially entitled immediately before his death.

(4) If, at a time before the end of the relevant period, any property ceases to be property subject to a reservation, the donor shall be treated for the purposes of the 1984 Act as having at that time made a disposition of the property by a disposition which is a potentially exempt transfer."

7.2 The key to applying s.102 is to identify the property which is the subject of the gift.

7.3 On the face of it, the natural conclusion is that it is the whole Policy which is settled and which 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

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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).

7.4 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. So in *Ingram & Palmer-Tomkinson (Lady Ingram's Executors) v CIR* HL [1999] STC 37 the taxpayer transferred property to a nominee which had granted her a lease of the property for twenty years and then made a gift of the freehold. It was held that the donated property was the freehold subject to the lease and the lease was not a reservation of benefit. That case, however, concerned a current and vested interest in property (the lease) which was not subjected to the trusts to which the freehold was subjected.[39] 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. So, on the face of it, it is likely (although perhaps not certain) that the property which is the subject of the gift is the whole interest in the Policies and the Original Policyholder's Reversionary Interest has the result that that property is subject to a reservation within FA 1986 s.102(2).

7.5 On the 10th December 1986, however, shortly after the introduction of the reservation of benefit rules into Inheritance Tax, the Law Society's Gazette recorded:-

> "In a separate development, the Revenue has confirmed to the Association of British Insurers that the following do **not** constitute gifts with reservation:
>
> (a) A whole life policy effected by the life assured in trusts [sic] for X should X survive the life assured but otherwise for the life assured.
>
> (b) An endowment effected by the life assured in trust for X if living at the death of the life assured before the maturity date but otherwise for the life assured."

7.6 The trusts referred to by way of example in this correspondence are not the same as those arising under the Arrangement. In the trusts described in the extract from the Law Society's Gazette the settlor's reversion is contingent on a beneficiary dying before the settlor. Under the Arrangement the Reversionary Interest is contingent upon the settlor surviving until a fixed future date.

7.7 On the 18th May 1987 the Inland Revenue (as it then was) published its views on the operation of the gifts with reservation rules in a letter of that date. Paragraph 7 of that letter said:-

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[39] A similar point could be made in relation to the lease considered in relation to New South Wales Stamp Duties in *Munro v Commissioners of Stamp Duties of New South Wales* TC [1934] AC 61

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"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."

7.8 Together these pieces of correspondence suggest that HMRC accepts that a reversionary interest to the settlor, even if contingent, will be carved out of the property transferred into the settlement rather than being a reservation in the settled property.

7.9 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. If, however, as I have suggested, HMRC's view is incorrect reliance on that view has some risks. In the light of *Wilkinson*[40] it is doubtful whether HMRC has the power to apply an incorrect view of the law to relieve a taxpayer of liability to tax. In *Garnett v Jones,* [41] *HMRC v Grace*[42] and *Genovese v Revenue & Customs Commissioners*[43] HMRC have shown a willingness to renege on their long standing practices in pursuit of an increased tax yield.

Finance Act 1986 Sch 20 Para 7

7.10 Finance Act 1986 Sch 20, para 7 provides:-

"7 -

(1) Where arrangements are entered into under which -

(a) there is a disposal by way of gift which consists of or includes, or is made in connection with, a policy of insurance on the life of the donor or his spouse [or civil partner][1] or on their joint lives, and

(b) the benefits which will or may accrue to the donee as a result of the gift vary by reference to benefits accruing to the donor or his spouse [or civil partner][1] (or both of them) under that policy or under another policy (whether issued before, at the same time as or after that referred to in paragraph (a) above),

the property comprised in the gift shall be treated for the purposes of the principal section as not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor.

(2) In sub-paragraph (1) above –

(a) the reference in paragraph (a) to a policy on the joint lives of the donor and his spouse [or civil partner][1] includes a reference to a policy on their joint lives and on the life of the survivor; and

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40 *R (oao Wilkinson) v CIR* HL [2006] STC 270
41 *Garnett v Jones (Re Arctic Systems Ltd)* HL [2007] STC 1536
42 *Revenue & Customs Commissioners v Grace* ChD [2009] STC 213
43 *Genovese v Revenue & Customs Commissioners* [2009] STC (SCD) 373

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(b) the reference in paragraph (b) to benefits accruing to the donor or his spouse [or civil partner][1] (or both of them) includes a reference to benefits which accrue by virtue of the exercise of rights conferred on either or both of them."

7.11 As Counsel says in his Opinion:-[44]

> "This case does not involve a policy on the life of the Settlor or spouse (or civil partner) of the Settlor and, accordingly, paragraph 7 of Schedule 20 to FA 1986 does not, in my opinion, have any relevant application."

Capital Gains Tax

7.12 There will be no Capital Gains Tax consequences from the death of the Original Policyholder. The Policies, other than those surrendered which have vested in Mr Fillbarrell and matured during his lifetime, will continue to be held on the trusts of the Settlement.

Income Tax

7.13 No chargeable events will arise by virtue of Mr Fillbarrell's death.[45]

7.14 The calculation of the amount chargeable under the Pre-Owned Assets Charge is made by reference only to the period from the beginning of the fiscal year to Mr Fillbarrell's death.[46]

THE ADVANCE OF POLICIES 51 TO 55 FOLLOWED BY THEIR SURRENDER

Inheritance Tax

The Advance

8.1 The advance of Policies 51 to 55 to the Beneficiaries will be the occasion of an exit charge under s.65. Because the advance takes place before the first decennial of the Settlement the calculation of that charge is governed by s.68. Under sub-section (1) ibid the rate at which tax is charged is:-

> "… the appropriate fraction of the effective rate at which tax would be charged on the value transferred by a chargeable transfer of the description specified in sub-section (4) [ibid] …"

8.2 Without looking at the constituent parts of this rule in detail it is sufficient to say that because Mr Fillbarrell has made no transfers of value other than the Assignment, the rate on the advance of Policies 51 to 55 will be nought per-cent.

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44 See para 28 of Counsel's Opinion

45 ITTOIA 2005 s.484(1)(a)

46 Although, of course, we have seen (at paras 4.4.24 – 4.4.31) above that it may be inferred from HMRC's published views that the Pre-Owned Assets Charge will not apply to the Arrangement

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The Surrender

8.3 The surrender of the Policies will not result in the diminution of the estate of the surrendering Beneficiaries and therefore the surrender will not be a transfer of value.

Capital Gains Tax

8.4 Both the advance of the Policies and their surrender will be disposals by the trustees but any gains arising on the disposals will not be chargeable gains[47] and any losses will not be allowable losses.[48]

Income Tax

The Advance

8.5 The advance of the Policies from the trustees to the Beneficiaries, being an assignment for no consideration, will not be a chargeable event.[49]

The Surrender

8.6 The surrender of the Policies will be a chargeable event and the Beneficiaries will each make a chargeable event gain, calculated as follows:-

	BENEFICIARY A	BENEFICIARY B
Surrender proceeds	13,426	13,426
Premia paid under the Policies	8,275	8,275
Chargeable event gain	5,151	5,151

8.7 The Beneficiaries will be charged to Income Tax in the fiscal year 2018/2019. Because the Policies are foreign policies of life insurance[50] the Beneficiaries will not be treated as having paid Income Tax at the basic rate on the chargeable event gain.[51]

THE MATURITY OF POLICIES 46 TO 50

Inheritance Tax

9.1 The maturity of the Policies will not be a transfer of value.

47 TCGA 1992 s.210(2)
48 TCGA 1992 s.16
49 ITTOIA 2005 s.484(1)(a)
50 Within the definition of ITTOIA 2005 s.476
51 ITTOIA 2005 s.531

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Capital Gains Tax

9.2 No chargeable gain or allowable loss will arise on the maturity of the Policies because the rights under the Policy will not at any time have been acquired for any actual consideration, other than consideration given by way of payment of premia under the Policies.[52]

Income Tax

9.3 The maturity of the Policies will be a chargeable event. The chargeable event gain will be calculated as follows:-

	£
Surrender proceeds	26,958
Premia paid under the Policies	16,550
Chargeable event gain	10,408

9.4 Because the Original Policyholder is dead at the time that the chargeable event gains accrue, the trustees are UK resident and the trusts of the Settlement are not charitable trusts, the chargeable gain will be treated as income of the trustees.[53] The gain will be subject to Income Tax at the trust rate.[54]

THE FIRST DECENNIAL OF THE SETTLEMENT

Inheritance Tax

10.1 The tenth anniversary of the making of the Settlement will be an occasion of charge under s.64.

The Method of Computation

10.2 The amount charged is computed by applying a rate calculated under s.66 to the value of the relevant property in the settlement. All of the settled property in the Settlement will be relevant property. The rate charged under s.66 is:-

> "… three tenths of the effective rate at which tax would be charged on the value transferred by a chargeable transfer of the description specified in sub-section(3) [ibid] …"

10.3 Sub-section (3) provides that the chargeable transfer postulated is one under which the value transferred is equal to an amount determined in accordance with further detailed provisions contained in sub-section (4) and which is made immediately before the ten

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52 TCGA 1992 ss.16 and 210(2) & (3)
53 ITTOIA 2005 s.467
54 ITA 2007 s.479. The trust rate in 2009/2010 is 40% and will be 50% in 2010/2011

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year anniversary concerned by a transferor who has in the preceding seven years made chargeable transfers of an aggregate value determined under further detailed provisions under sub-section (5). Sub-section (5) provides that the aggregate is the value transferred by any chargeable transfers made by the settlor in the period of seven years ending with the day on which the settlement commenced and the amounts on which any charges to tax have been imposed under s.65 in the ten years before the anniversary concerned.

The Effect of Previous Charges under Section 65

10.4 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.[55] HMRC's position, however, appears to be that a charge will not arise in these circumstances.[56] This in turn will affect the calculation of the charge on the succeeding decennial which in turn will affect the calculation of exit charges under s.65 in the ten years after that decennial.

10.5 The effective rate on the basis that a charge arises under s.65 on the vesting of the Reversionary Interest is calculated as follows:-

	£	£
Value transferred under s.66(4)		404,370
By a person with previous chargeable transfers determined under s.66(5):-		
Chargeable transfers of settlor in seven years before settlement	0	
Amounts on which tax has been charged under s.65 in previous ten years (23,288 + 24,452 + 25,674 + 26,852)	100,266	
		100,266
		504,636

Because the Nil-Rate Band at the decennial is £505,000, tax charged would be charged at 0% on £404,370

10.6 The effective rate on the basis that a charge does not arise under s.65 on the vesting of the Reversionary Interest is calculated as follows:-

[55] See para 4.6.1 above

[56] See para 4.6.2 – 4.6.9 above

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	£	£
Value transferred under s.66(4)		404,370
By a person with chargeable transfer determined under s.66(5):-		
Chargeable transfers by settlor in seven years before settlement	0	
Amounts on which tax has been charged under s.65	26,852	
		26,852
		431,222

Because the Nil-Rate Band at the decennial is £505,000, tax would be charged at 0% on £404,370

10.7 It can be seen that, although no tax charge arises under either computation if charges under s.65 do arise on the vesting of the Reversionary Interests only a small variation of the assumed amount of the Nil-Rate Band or in the surrender proceeds arising on the Policies would result in there being an actual charge to tax.

Capital Gains Tax and Income Tax

10.8 The first decennial of the Settlement has no significance for Capital Gains Tax or Income Tax.

THE SURRENDER OF POLICIES 1 TO 5

Inheritance Tax

11.1 The surrender of the Policies will not create a charge to Inheritance Tax.

An Exit Charge under Section 65?

11.2 We have seen that s.65 imposes a charge to Inheritance Tax on the trustees of a relevant property settlement in two circumstances.[57]

Section 65(1)(b)

11.3 The surrender of the Policy does not fall within s.65(1)(b) because the value of the relevant property comprised in the Settlement is not less by virtue of the surrender than it otherwise would be.

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[57] See para 4.5.3 above

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Section 65(1)(a)

11.4 Does it fall within s.65(1)(a) because the surrender results in the property comprised in the settlement or any part of that property ceasing to be relevant property? Of course, a policy which is surrendered ceases to be relevant property because it ceases to exist but it is replaced by the money paid by the insurance company on the surrender. Is it arguable that s.65(1)(a) refers to the totality of the property in the Settlement and asks whether that total has been reduced so that where an asset is replaced by another asset of equal value s.65(1)(a) is not satisfied?

11.5 The matter is not entirely clear but even if the conditions of s.65(1)(a) are satisfied the amount on which tax will be charged in such a situation would be nil. Section 65(2) provides that the amount on which tax is charged under that section is:-

> "(a) the amount by which the value of relevant property comprised in the Settlement is less immediately after the event in question than it would be but for the event; or
>
> (b) where the tax payable is paid out of relevant property comprised in the settlement immediately after the event, the amount which, after deducting the tax, is equal to the amount on which tax would be charged by virtue of paragraph (a) above."

11.6 Here it is clear that s.65(2)(a) does look at the value of all relevant property comprised in the Settlement. The surrender does not reduce the total value of the relevant property in the Settlement.

Capital Gains Tax

11.7 The surrenders of the Policies will be disposals by the trustees but any gain arising on the disposals will not be chargeable gains[58] and any losses will not be allowable losses.[59]

Income Tax

11.8 The surrenders of the Policies will be chargeable events. The aggregate chargeable event gains will be calculated as follows:-

	£
Surrender proceeds	27,632
Premia paid under the Policies	16,550
Chargeable Event Gains	11,082

[58] TCGA 1992 s.210(2)
[59] TCGA 1992 s.16

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11.9 Because the Original Policyholder is dead at the time that the chargeable event gains accrue, the trustees are UK resident and the trusts of the Settlement are not charitable trusts, the chargeable gain will be treated as income of the trustees.[60] The gain will be subject to Income Tax at the trust rate.[61]

THE SECOND EXERCISE OF THE EXTENSION RIGHTS IN RESPECT OF POLICIES 6 TO 25

Inheritance Tax, Capital Gains Tax and Income Tax

12.1 For the reasons explained in relation to the first exercise of the Extension Right the exercise of this right will have no effect for Inheritance Tax, Capital Gains Tax or Income Tax.

THE ADVANCE OF THE ENTIRE REMAINING TRUST FUND

Inheritance Tax

13.1 The advance of the entire trust fund to the Beneficiaries will be the occasion of an exit charge under s.65. Because that exit charge is calculated by reference to the rate of charge on the decennial preceeding the exit event,[62] the exit charge on the advance of the entire trust fund to the Beneficiaries will be at nought per-cent.

Capital Gains Tax

13.2 Because the rights arising under the Policies advanced have not at any time been acquired by any person for actual consideration, any gain arising on the advance of the Policies will not be a chargeable gain[63] and a loss will not be an allowable loss.[64]

Income Tax

13.3 Once again, because the Assignment by the trustees of the Policies to the Beneficiaries does 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.

THE SURRENDER OF THE REMAINING POLICIES BY THE BENEFICIARIES

Inheritance Tax

14.1 The surrender of the Policies will not result in the diminution of the estate of the surrendering Beneficiaries and therefore the surrender will not be a transfer of value.

[60] ITTOIA 2005 s.467
[61] ITA 2007 s.479. The trust rate in 2009/2010 is 40% and will be 50% in 2010/2011
[62] Sections 65(3) and 69
[63] TCGA 1992 s.210(2)
[64] TCGA 1992 s.16

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Capital Gains Tax

14.2 Both the advance of the Policies and their surrender will be disposals but any gains arising on the disposals will not be chargeable gains[65] and any losses will not be allowable losses.[66] In respect of both disposals this is because the Policies have at no time been acquired by any person for actual consideration and so s.210 will apply. In respect of the Beneficiaries' disposals it is also because they have not been resident or ordinarily resident during the fiscal year of disposal.[67] Section 210 will also prevent a chargeable gain arising under s.10A in respect of the Beneficiaries' disposals. Section 10A will apply if either of the Beneficiaries become either resident or ordinarily resident in the United Kingdom before the 6th April 2026.

Income Tax

14.3 The surrender of the Policies by the Beneficiaries will be a chargeable event and a chargeable event gain will arise.

14.4 No person will be liable for Income Tax in respect of that gain because immediately before the surrender the Policies are beneficially owned by individuals who are not resident in the United Kingdom at any time in the tax year in which the gain arises.[68]

THE LOMBARD INTERNATIONAL ACCUMULATION AND MAINTENANCE PLAN

THE PROBLEM

Finance Act 2006 Section 156 and Schedule 20

15.1 The changes to the Inheritance Taxation of Trusts made by Finance Act 2006 s.156 and Schedule 20[69] have the result that it is not possible to make a trust, other than a bare trust, designed to benefit an individual by way of a lifetime transfer which does not fall within the relevant property regime of Inheritance Tax Act 1984 Part 3 Chapter 3 unless the trust falls within a very limited class of privileged settlements. Parents and grandparents who wish to pass their wealth on trust to the succeeding generations during their lifetimes so as to minimise their Inheritance Tax liability on death must now either make an immediately chargeable transfer or an absolute gift on bare trusts. Under such an absolute gift the donee will receive unfettered control of the donated assets at the age of 18.

Protecting prodigal sons from themselves

15.2 At the time the changes were introduced, virtually the only people in the country who thought that they were a good idea were Government Ministers who, one presumes, have never had the parable of the Prodigal Son read to them. It is very rarely in the long-term

[65] TCGA 1992 s.210(2)
[66] TCGA 1992 s.16
[67] TCGA 1992 s.2
[68] ITTOIA 2005 s.465
[69] All references in this lecture are to the Inheritance Tax Act 1984 unless otherwise stated

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interests of an eighteen year old to be given unfettered control of substantial amounts of money. So advisers have turned their attention to finding ways in which gifts on bare trusts could be made of assets which it would be impossible, or at least, difficult, for a beneficiary to turn to account in the period during which he is insufficiently mature to be trusted to do so prudently.

The Company's Solution

15.3 It was a problem tailor-made for the insurance industry and commentators quickly suggested that a whole of life maximum investment policy on the life of the donor with restricted surrender rights would go a long way towards providing a solution. Lombard International Assurance SA (the "Company") is an insurance company incorporated, resident and carrying on insurance business in Luxembourg which is a member of the Friends Provident Group. It has created an arrangement, the "Accumulation and Maintenance Plan" (the "Plan"), to meet the demand for such policies which is being marketed as the successor to accumulation and maintenance trusts. This lecture describes the Plan and considers its taxation effects and whether it meets the need which it is designed to serve.

THE PLAN

16.1 In many ways, the policies issued under the Plan are absolutely conventional single premium insurance bond policies. The policy documentation includes an application form (the "Application Form"), a supplement to the application form (the "Supplementary Form"), a draft bare trust (the "Draft Trust Deed") and a draft deed of assignment (the "Draft Assignment"). The Company has kindly supplied all of these documents to the Author except the Application Form and has also supplied a marketing document describing the Plan (the "Plan Description"), its instructions to Counsel concerning the plan (the "Instructions") and Counsel's Opinion (the "Opinion") thereon.

The General Conditions

16.2 Policies issued under the Plan are governed by the Company's general conditions which are applicable to its whole of life "investment" policies generally. The policies are modified by two special conditions which apply only to policies issued under the Plan and which are set out in the Supplementary Form.

The Term and the Premia

16.3 The policies are single life, or joint life last survivor, whole of life policies. That is, if only a single person is insured, they mature on the death of that person. If two or more lives are insured, they mature on the death of the last of those persons to die.

16.4 The policy comes into existence on the payment of a premium and further premia may be added by the policyholder although the Company reserves the right to refuse such additional premia. The minimum permitted initial premium is £100,000 and the minimum additional premium is £10,000.

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The Notional 'Portfolio'

16.5 The benefits under the policy are calculated by reference to the value of a group of assets described as a 'portfolio' which are identified by a portfolio reference number in the accounts of the Company.

16.6 This group of assets is segregated in the accounts of the Company purely for the purposes of calculating the benefits paid under the policy. The assets comprised in the portfolio belong beneficially to the Company and not to the policyholder. The management of the assets is undertaken by the Company but the policyholder may set a broad investment strategy to be followed by the manager and he may change this broad strategy from time to time. It is a specific term of the policy that the policyholder has no right either to manage the underlying assets or to exercise any control over them whatsoever although this must be subject to the policyholder's right to set the broad investment strategy.

16.7 Rather unusually, the Company maintains a separate portfolio for each policy although the investments comprised in the portfolio may include holdings in the Company's funds. It is more normal, for an insurance company to create a single fund for the purposes of all or a group of the investment policies which it issues notionally divided into units, the units being allocated to individual policies for the purpose of calculating policy benefits.

Policy Benefits

16.8 When the policy is surrendered in whole an amount (the "Surrender Benefit") becomes payable to the policyholder which is equal to the value of the portfolio. On part surrender, a proportionate amount of the Surrender Benefit is payable. When the policy matures (on the death of the life assured or the last death of the lives assured) a benefit (the "Maturity Benefit") becomes payable which is equal to the portfolio value at the time of death plus an additional amount which is the lower of 1% of that value and £5,000. It is possible to opt for the Maturity Benefit to be increased by an additional amount to provide a larger differential between the surrender value and the maturity benefit increasing what one might call, loosely, the real insurance element of the Plan. An additional charge is then made against the portfolio value.

Charges

16.9 Charges are made under various heads by the Company against the value of the portfolio and third party transaction costs are also charged against it.

16.10 The general policy conditions do not define the method of computing these charges with exactitude and so it will be necessary for the policyholder, or his adviser, to agree a basis of charge at the time of taking out the policy if the Company are not to be left with a large degree of discretion in calculating its charges. Even so it is a specific term of the policy that the Company has the 'right to increase the charges at any time' subject to giving the policyholder one month's notice and an explanation of the circumstances of the increase.

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16.11 If the contract is surrendered before the expiry of an initial period, an early surrender charge may be deducted from the portfolio value in calculating the Surrender Benefit. The general policy conditions do not define the term of the initial period or the amount of the early surrender charge and so, again, this is a matter to be specifically agreed before the policy is issued.

Unrestricted Right of Assignment

16.12 The policyholder from time to time has a right to assign or otherwise charge the rights conferred under the contract.

The Supplementary Form

Surrender and Withdrawal Rights

16.13 Under the General Conditions, the policy may be surrendered in whole or in part by the policyholder by written notice at any time. Regular withdrawals may be made at quarterly, six-monthly or annual intervals of an amount that is specified by the policyholder.

16.14 The Supplementary Form, however, contains provisions which modify the general conditions. On applying for a policy the applicant may specify on the Supplementary Form an initial period in whole years during which there will be no option to surrender the policy in whole or in part. He may also specify an initial period of whole years during which the regular withdrawal right is restricted to a cumulative annual percentage which may not be more than 5%.

The Draft Trust Deed

16.15 The draft Trust Deed is in the form of a declaration by the original policyholder that the policy is to be held on trust for a single beneficiary absolutely. The form names the settlor as one of two trustees.

16.16 Of course there is no reason why an individual should not use a bespoke trust deed. As this product is aimed at those settling sums on children and young adults sufficient to cause the donor's transfers to exceed his Nil-Rate Band it is likely that the sums concerned will be sufficiently large that it would be imprudent to undertake the transaction without taking proper professional advice including advice on the terms of an appropriate bare trust.

The Draft Assignment

16.17 Under the Draft Assignment the policy may be assigned. It provides space for only one assignee and provides that:-

> "… the Assignor as beneficial owner hereby assigns unto the Assignee all that the Policy/ies and all monies which are assured thereby and all benefits and other

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monies which may become payable in respect thereof to be held by the Assignee as beneficial owner free from any trust or encumbrance."

16.18 The Plan Description, however, states that under the Plan, the original policyholder, having been issued with the policy:-

> " … then assigns the policy by way of outright gift to, or to bare trustees for, a child, grandchild, relative or third party."

16.19

AN EXAMPLE

Harry Masters is a very wealthy man. He has made no previous chargeable transfers. He wishes to make a transfer of his wealth in favour of his son Dabinett, so as to make a potentially exempt transfer whilst he is young enough to have a good chance of surviving the gift by a period sufficient to allow it to fall out of charge for Inheritance Tax purposes. He takes out a policy under the Plan paying a single premium of £1,500,000 and completes the standard Draft Trust Deed in respect of the policy appointing himself and his wife as trustees and naming Dabinett as the sole beneficiary. He then immediately assigns the policy to himself and his wife jointly using the Draft Assignment and sends the assignment to The Company for registration. Dabinett was ten years old on 30th June 2009, and, in general, Harry thinks that one is not usually mature enough to have unfettered control of substantial wealth until one is 30 so on taking out the policy he opts for the surrender right to be suspended until 30th June 2029 and he excludes all regular withdrawals until that date. The market value of the policy subject to these restrictions at the time that the policy is assigned is £1,030,000.

Harry Masters dies on 21st February 2024 when Dabinett is a little over 25 years old. The portfolio value at that time is £2,940,000. The policy matures on Harry Masters death and pays out a maturity benefit of £2,945,000 (£2,940,000 + £5,000) to Mrs Masters, as the surviving policyholder. She receives it as bare trustee for Dabinett and, at his request, she pays it to him.

It is assumed that current tax rules are not altered in subsequent years.

TAXATION ANALYSIS

17.1 We shall now consider the taxation effects of the policy by reference to the facts in the boxed Example.

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The Contract is Made

A transfer of value?

17.2 When he takes out the policy, the policyholder makes a disposition. That disposition will be a transfer of value if it results in a decrease in the value of the estate of the person making it.[70] In our Example, Harry makes a transfer of value because, before entering into the policy his estate contains cash of £1,500,000 and after entering into it his estate no longer contains that cash but rather has a bundle of rights under the policy which has a market value of £1,030,000. He therefore makes a transfer of value of £470,000. In fact, one would expect that in virtually every case there will be a transfer of value. The policy involves giving up a right to access the funds invested in it wholly or partly for a period. No enhanced return is offered for tying up one's money in this way as it would, for example, if one made a fixed term deposit with a bank. That being the case, the value of the policy when it is made is almost certain to be less than the initial premium paid in respect of it. Whether that reduction in value will be significant will depend on the amount of the premia, whether withdrawal rights as well as surrender rights are suspended and the lengths of the suspension periods.

Is it an exempt transfer?

17.3 The transfer of value will not be a potentially exempt transfer because, although it is made by an individual, it is not a gift to an individual or to a privileged trust.[71] Indeed, it is arguable that it is not a gift at all. It will be a chargeable transfer unless it is exempt under any provision.[72] The Opinion suggests that it will not be a chargeable transfer because it will be exempt under IHTA 1984 s.10. Sub-section 1 of that section provides that:-

> "(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either -
>
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
>
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other."

17.4 For this purpose a 'transaction' includes a series of transactions and any associated operations.[73] It seems clear that the making of the contract, the declaration of trust over the contract and the assignment of the contract to the trustees are a series of transactions (and they are also, of course, associated operations) and, therefore, that the transaction to

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[70] Section 3(1)
[71] Section 3A(1A)
[72] Section 2
[73] Sub-section (3) ibid

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be considered for the purpose of applying s.10(1) is a composite transaction which includes the settlement of the policy and its assignment to the trustees.

17.5 That being the case, it is difficult to see how the disposition consisting of the making of the policy can satisfy the condition that it "… was not made in a transaction intended to confer any gratuitous benefit on any person."

17.6 As we shall see, the Opinion, in concluding that the making of the policy will probably be an exempt transfer under s.10, also finds support in a purposive argument. As that argument depends upon considering the valuation of the transfer of value which takes place on the assignment it is considered below. It is there concluded that it does not have sufficient weight to demonstrate that the exemption is applicable.

17.7 On that basis, the possibility that the making of the contract will be an immediately chargeable transfer is a weakness of the Plan and it will be necessary, for any person implementing it, to pay careful attention to the valuation of the policy at the time it is taken out. The reduction in the value of the original policyholder's estate in many instances may be within the Nil-Rate Band and may, in some cases, be quite small. If the premia paid in our example had been £750,000 not £1,500,000 the reduction in Harry Masters' estate would have been in the region of £235,000 (£470,000 x £750,000/£1,500,000), well within the nil rate band. The problem will also be mitigated if the withdrawal option is chosen so that regular withdrawals may be made from the policy. In that case, because it would be possible for the policy holder to benefit from the policy to some degree whilst the surrender right is suspended, the depreciation in value on entering into the policy will be reduced. On the other hand, the beneficiary's ability to turn the policy to account by selling it or using it as security for borrowing will then be increased which rather defeats the purpose of the Plan.

The Assignment on Bare Trust

Inheritance Tax

17.8 The assignment on bare trust will be a transfer of value which will not be exempt but rather will be a potentially exempt transfer. That is because it will satisfy the conditions that it is:-

(a) made by an individual on or after the 22nd March 2006;

(b) would otherwise be a chargeable transfer; and

(c) constitutes a gift to an individual.[74]

17.9 In determining the value transferred the special rule in s.167 will apply. Section 167(1) and (2) provide that:-

[74] Section 3A(1A)

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“(1) In determining in connection with a transfer of value the value of a policy of insurance on a person’s life or of a contract for an annuity payable on a person’s death, that value shall be taken to be not less than –

(a) the total of the premiums or other consideration which, at any time before the transfer of value, has been paid under the policy or contract or any policy or contract for which it was directly or indirectly substituted, less

(b) any sum which, at any time before the transfer of value, has been paid under, or in consideration for the surrender of any right conferred by, the policy or contract or a policy or contract for which it was directly or indirectly substituted.

(2) Subsection (1) above shall not apply in the case of –

(a) the transfer of value which a person makes on his death, or

(b) any other transfer of value which does not result in the policy or contract ceasing to be part of the transferor’s estate”[75]

17.10 The result of this is that the measure of the potentially exempt transfer arising on the assignment will be the premium paid under the policy. In our example that would be £1,500,000.

17.11 There is obviously an element of double accounting here. If Harry Masters were to die immediately after subjecting the policy to bare trusts in favour of his son, Dabinett, he would have made a chargeable transfer of £470,000 and, shortly afterwards, a potentially exempt transfer of £1,500,000 which, by reason of being within seven years of his death, would have proved to be a chargeable transfer. Inheritance Tax would have been charged on £1,970,000 (£1,500,000 + £470,000) whereas his estate in reality would only have been reduced by £1,500,000. That is obviously an anomalous result and, on the basis of it, Counsel argues in the Opinion that HMRC are unlikely to take the point that there is a chargeable transfer of value at the time that the contract is made because, on a purposive construction, s.10 is to be taken to apply to it.

17.12 The basis of this view is that the purpose of s.167 is to prevent avoidance of tax through the payment of premia for policies subsequently given away which are worth less than the premia paid for them. Counsel points out that in the case of the Plan, a potentially exempt transfer arises on the assignment which is plainly not less than the premium paid with the result that there is no tax avoided. Counsel does go on to say, however, that it will be safer for the policy holder to have limited five percent withdrawal rights during the initial period, presumably on the basis that the withdrawal rights would increase the value of the policy so that, if he were wrong in considering that the making of the policy will be exempt under s.10, the measure of the chargeable transfer arising at that time would be reduced.

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[75] It is because of sub-section (2)(a) ibid that the valuation rule does not apply on the making of the contract

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17.13 The problem with this view is that s.167 is only in point if the transferor dies within seven years of the gift so that what would otherwise be a potentially exempt transfer becomes chargeable. It is difficult to see how a consideration of the purpose of a provision governing a later transfer of value, which may never become chargeable, can condition the construction of the provisions relevant to the making of the policy. It may be that a purposive argument could be mounted to disapply s.167 in determining the amount of the transfer of value on the assignment but the author would not be sanguine even to that extent. Such a construction would do considerable violence to the statutory words which the Courts are rarely willing to do in the taxpayer's favour.

17.14 So not only would it appear that the making of the policy creates an immediately chargeable transfer but there also appears a real risk that s.167 could have the effect that a double charge to Inheritance Tax would be created by the Plan.

17.15 In practice, where the five percent withdrawal option is exercised, it may be that the premium paid would have to be extremely high before a significant charge would arise on the making of the policy and for there to be a significant element of double counting. Nonetheless, this is a major concern about the product and a person considering using it would need to consider the question of valuation extremely carefully before doing so.

Income Tax

17.16 A policy taken out under the Plan will be a non-qualifying policy of life assurance for the purposes of ITTOIA 2005 Part 4 Chapter 9 and it will be a foreign policy for those purposes.[76] If there is a chargeable event in respect of the policy on which a chargeable event gain arises and the beneficiary is UK resident, that gain will form part of the beneficiary's assessable income subject to both basic and higher rate Income Tax as appropriate.[77] The assignment of rights under a life assurance policy, however, is not a chargeable event for these purposes so the assignment by the original policy holder to the trustees will not give rise to a chargeable event gain.

The Maturity of the Policy

Inheritance Tax

17.17 When the policy matures on the death of the life assured (or on the death of the last life assured to die) it will not form part of the life assured's estate and so it will not be subject to Inheritance Tax at that time. So, in our example, the policy proceeds of £2,945,000 do not bear Inheritance Tax. As we have seen, if the life assured were to die within seven years of making a gift of the policy, that would result in his potentially exempt transfer proving to be a chargeable transfer.

[76] ITTOIA 2005 s.476(3)
[77] ITTOIA 2005 s.465(2), s.491, s.461 and s.463

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Income Tax

17.18 The maturity of a non-qualifying policy of life assurance by reason of a death which gives rise to the payment of benefits under the policy will be a chargeable event. In calculating the chargeable event gain, however, the value of the policy taken into the calculation is not the amount payable on the maturity of the policy on the death but rather the value for which it could have been surrendered immediately before the death.[78] So if the death occurs during the period in which the surrender right is suspended, and there is no withdrawal right, the value of the policy for the purposes of calculating the chargeable event gain will be nil and therefore there will be no chargeable event gain.

17.19 Where withdrawal rights are retained, there will be a value for the policy within ITTOIA 2005 s.493 but it is unlikely that in those circumstances the total benefit value of the policy would be less than the deductions to be made in calculating the chargeable event gain under s.491(2) ibid.

17.20 If the policy were to mature after the suspension period expires, however, when the policy had acquired surrender rights, the accumulated yield on the policy would be subject to Income Tax because, in effect, it would create a chargeable event gain. If, in our example, Harry Masters had provided for the surrender rights to be suspended only until Dabinett's twenty fourth birthday on the 30th June 2023, there would have been a chargeable event gain on Harry's death of £1,440,000 (£2,940,000 - £1,500,000) forming part of Dabinett's assessable income for 2023/2024. Harry's survival for a little less than eight months after the suspension of the surrender rights would have proved to be very costly indeed. Assuming that Dabinett pays a marginal rate of Income Tax of forty percent it would have cost £576,000 (£1,440,000 @ 40%).[79]

IS THE PLAN THE SOLUTION TO THE PROBLEMS CREATED BY FA 2006?

An effective transfer of wealth

18.1 Subject to the points raised in this lecture concerning the possibility of a chargeable transfer arising on the making of the policy and of a double charge to Inheritance Tax on the donor failing to survive his gifts by seven years, the Plan does seem to fulfil its purpose of allowing an effective transfer of wealth to be made out of the donor's estate for Inheritance Tax purposes in favour of a donee.

18.2 The net result of Harry Masters' transaction in our example, for example, is that he has removed £2,945,000 from his estate (including investment growth of £1,445,000) and only £470,000 of that amount has borne Inheritance Tax. Because of the application of the nil rate band and the annual exemptions and because the lifetime rates of Inheritance Tax apply, the total Inheritance Tax suffered is just £27,800 (20% (£470,000 –

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[78] ITTOIA 2005 s.493(7)

[79] Of course, the highest rate of Income Tax is due to be increased to 50% in 2010/2011. It is to be hoped that by 2023/2024 economic sanity will have been restored

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(£325,000 + £3,000 + £3,000)) and, ignoring withholding tax suffered by the Company, there has been no Income Tax or Capital Gains Tax on the investment yield at all.

Does the Plan fully protect against the Donee's Improvidence?

18.3 One might go on to ask though whether the Plan succeeds in allowing a donor to make a gift which prevents the donee squandering the wealth which he is given? The answer is that it will do so only partially.

Control of Investment Strategy

18.4 First, if an outright assignment is made, the donee will control the broad investment strategy of the investments linked to the policy by virtue of the policy holder's right to set that strategy. If the property is assigned to trustees, the trustees will hold that right but it will be subject to a duty to transfer the policy to the beneficiary at his request as from the age of eighteen.

Donee can Sell or Charge the Policy

18.5 Secondly, and much more significantly, the donor cannot prevent the donee from selling the policy or using it as security for his borrowing. It may well be that only the most improvident beneficiary would do so because it is highly unlikely that he would be able to sell or pledge the policy for an amount anywhere near the portfolio value. That is because the policy will be an illiquid asset (because of the suspension of the surrender rights) of an unusual class and because potential purchasers may be afraid that an obstructive trustee would delay dealing with the policy in accordance with the beneficiary's instructions. If the policy includes withdrawal rights, however, the discount for illiquidity would be reduced and the latter difficulty could be overcome by the beneficiary requiring the trustees to advance the policy to him before selling or pledging it.

Suspension Period must be fixed in advance

18.6 It is not always easy to predict how one's children (or grandchildren) will develop in the future. Some people are financially prudent when very young, others never become so. One of the difficulties of the Plan is that it requires the original policyholder to determine the period for which the surrender rights and withdrawal rights are to be suspended before the policy is issued.

Early Death of Life Assured gives premature control of wealth to Donee

18.7 Another drawback of the strategy is that if the life assured dies earlier than expected then, as in our example, the beneficiary's illiquid asset will be turned into highly liquid cash prematurely. The chances of the policy maturing earlier than expected could be reduced by writing the policy on multiple lives.

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A real, if temporary, diminution of wealth

18.8 Perhaps there is a more fundamental point to be made. We have seen that the value of the policy immediately after it is made will be less than the premium paid in respect of it. That represents a real drop in the market value of the donor's assets or, one might say, of the total assets of the donor and his family. It is true that the value will be recovered once the policy either matures or accrues surrender rights after the suspension period but the drop in the policy's value in the meantime represents a real, if temporary, drop in the family's wealth.

A MARK II PLAN?

19.1 Is there another approach which might be taken?

Overcoming the Double Charge

19.2 The possibility of a double charge which we have identified in para 5.3.11 above would be removed if the policy and the bare trust were to come into existence simultaneously. That would be possible provided Luxembourg, in common with many offshore jurisdictions, does not have in its insurance law a requirement for the initial beneficial policyholder to have an insurable interest in the lives assured under the policy. Such an arrangement, however, might make it more probable that the Courts would regard the retention of a right of veto over a surrender[80] or an activation right[81] as creating a reservation of benefit in the Policy concerned.

A Right of Veto over Surrender

19.3 The product would offer greater flexibility if the original policyholder were given a right of veto over any proposed surrender or partial surrender of the policy, a right which would be retained when the policy is assigned. In that way, it would not be necessary for the policy holder to estimate the age at which the beneficiary would be sufficiently mature to be trusted with wealth at the time the policy was made and it would be possible to extend for a very long period, indeed, the period of veto, perhaps until the final maturity of the policy. As the right of veto would be an item of property, but one with a very low value, it would be possible for the settlor to settle it on discretionary trusts without creating a significant inheritance charge on the settlement or creating material decennial charges under s.64.

Reservation of Benefit?

19.4 The obvious technical worry is that the right to veto a surrender might be a reservation of benefit within FA 1986 s.102(1) on the basis that possession and enjoyment of the property would not have been bona fide assumed by the donee or, alternatively, or additionally, because the donated property would not be enjoyed to the entire exclusion of the donor. In the author's view there would be little risk of there being a reservation

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[80] See paras 5.5.3 – 5.5.6
[81] See paras 5.5.7 and 5.5.8

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of benefit in the property because the gift would be a gift of the right to benefit under the policy subject to the retained rights[82] except in circumstances where the Policies and the Settlement come into existence simultaneously.[83]

19.5 In any event, if there was felt to be a real risk of the provision applying, the settlement of the right of veto on discretionary trusts from which the donor was excluded might ensure that the reservation of benefit immediately came to an end.

19.6 The Pre-Owned Assets Charge could not apply to the arrangement because the donor's gift would not be a gift of land and chattels and, if the right of veto were settled, it would be settled on trusts from which the donor was excluded.[84]

An Activation Right

19.7 One drawback of this suggestion for a Mark II Plan is that, because there would be a surrender benefit at all times, the yield on the policy would be subject to a chargeable event gain charge whenever the policy matured.

19.8 An alternative approach might be to provide that there would be no right to surrender the policy subject to an option for such a right to be activated. The option would be expressly capable of assignment separately from the other rights under the policy. Once the ownership of the policy and the activation right had been separated it is difficult to see how there could be a surrender value for the purposes of ITTOIA 2005 s.493 at any time before the right is exercised. The activation right could be settled in the same way as the right of veto proposed above.

CONCLUSION

20.1 The Plan gives considerable scope for allowing gifts to be made in the favour of children and young adults whilst protecting them from the effects of their own improvidence. That protection is not absolute. The possibility of creating a chargeable transfer on making the policy and of creating a double charge to Inheritance Tax in the event that the donor dies within seven years of his gift, has the result that careful attention needs to be given to matters of valuation. It will be interesting to see whether the Company creates a second generation of plans making use of severable rights of veto or of an activation option in the way discussed in the final part of this lecture.

[82] See *Munro v Commissioners of Stamp Duties of New South Wales PC* [1934] AC 61
[83] See para 5.5.2 above
[84] FA 2004 Sch 15 paras 3, 6 and 8

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