INHERITANCE TAX PLANNING - TRUSTS, INSURANCE AND ALTERNATIVES:

AN ANALYSIS OF INSURANCE POLICIES USED IN ADVANCED INHERITANCE TAX PLANNING

Part I

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Simon McKie

MA (Oxon), Barrister, FCA, CTA (Fellow), APFS, TEP

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Rudge Hill House
Rudge
Somersetshire
BA11 2QG

Tel: 01373 830956
Email: simon@mckieandco.com
Website: www.mckieandco.com

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LOAN TRUSTS

THE ARRANGEMENT

Introduction

1.1 Loan Trust arrangements have been in existence for many years. In this lecture we examine an example of such arrangements (the "Arrangement") offered by Royal Skandia Life Assurance Limited (the "Company"), a company registered and resident in the Isle of Man.

Information Supplied

1.2 The Company has been very helpful in providing a package of information concerning the bond which includes Counsel's Opinion on the arrangement, Instructions to Counsel, four different standard Trust Deeds for use in the Arrangement, standard loan agreements and a variety of information sheets which are given to advisers and their clients including sheets giving the key features of the collective investment bond[1] and the collective redemption bond[2] used in the Arrangement.

Entering into the Arrangement

1.3 A person (the "Lender") wishing to enter into the Arrangement enters into a trust deed. There are two forms of trust; a bare trust and a discretionary trust. There are two versions of each form, one written under English Law and one under Manx Law. In this lecture we concentrate primarily on the discretionary version of the trust written under Manx Law.

The Trust Property

1.4 The trusts take a rather peculiar form. Clause 3 of the deed provides that:-

> "The Settlor agrees with the original trustees to lend them [an amount chosen by the Lender] to hold on the trusts of the settlement (hereinafter referred to as "the Loan"). The original trustees requested that the loan be made by payment of a cheque or payment by electronic transfer (where appropriate) to Royal Skandia Life Assurance Ltd or the trustees of the trust named in clause 4(b) below."

1.5 Could the trustees, having received the moneys under the loan, simply decide not to create the trusts? It seems not because clause 3 of the deed creates a contractual agreement between the settlor and the persons who are to be trustees that the loan is made on condition that the moneys lent are subjected to the trusts.

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1 See para 2.1.12 below
2 See paras 2.1.12 and 2.1.13 below

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The Settlor

1.6 Because it is the moneys lent which are the subject of the trust it must be the persons who are to become trustees, and not the Lender,[3] who create the trusts over the moneys for those moneys cannot be subjected to the trusts until they have become the borrower's property. That will be when the Lender's cheque or electronic transfer has cleared through the banking system.

1.7 The trust deed provides alternatively, for there to be one settlor or two. Where there are two settlors, clause 3(2) provides that "the loan shall be deemed to have been provided in equal shares and made as joint tenants."

The Loan

1.8 Clause 3(3) provides that the loan is to be free of interest and repayable on written demand by the settlor to the original trustees. There is no provision in the trust deed to limit the trustees' liability under the loan to the amount of the trust fund and it is assumed in the instructions, in Counsel's Opinion and in the Company's documentation that, in the event that the trust fund is insufficient to repay the loan, the Lender will be able to recover against the individual assets of any of the trustees.

1.9 The contrary view is that because the loan is expressly made to the trustees "to hold on the trusts of this settlement" it is an implied term of the loan that recourse for its repayment is to be had only to the trust fund.

1.10 In the remainder of this lecture we assume that the trustees will be jointly and severally liable to repay the loan.

The Discretionary Trusts

1.11 Under the Discretionary Trust, the trust fund is to be held on conventional, broad discretionary trusts in favour of a class of beneficiaries which includes the children and descendants of the settlor, the spouses, former spouses, widows, widowers, civil partners, former civil partners and surviving civil partners of any of those children or descendants, any company body or trust established for charitable purposes only and any persons added by deed by the settlor (or settlors). The settlor and the settlor's spouse or civil partner cannot be added to the beneficial class and clause 16 provides that:-

> "… no power conferred by this Settlement shall be exercisable and no provision shall operate so as to allow the Trust Fund or its income to become payable to or applicable for the benefit of the Settlor in any circumstances whatsoever."

The Policies

1.12 Two different types of policies may be used under the Arrangement. First, a "Collective Redemption Bond" which is a bond intended to be a capital redemption policy within

[3] Even though in the trust deed the Lender is referred to as the Settlor

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ITTOIA 2005 s.473(2) which matures ninety nine years after issue. Secondly, a "Collective Investment Bond" which is a whole of life insurance policy written on multiple lives assured (who should not include the Lender or his spouse) and which matures on the death of the last of the lives assured to die. It is not expected that either type of policy will be maintained until its maturity date.

The Lives Assured

1.13 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 policyholders, the Policies under the Arrangement are written on joint or multiple lives. Even so, having multiple lives assured does require one to choose suitable people. If too many are chosen, it may be inconvenient to keep track of them. If only a small number are used, there is a risk that their unexpectedly early death may bring the Arrangement to a premature end. The Collective Redemption Bond, as a Capital Redemption Policy, does not have a life assured but matures on a fixed date. Using a Collective Redemption Bond rather than a Collective Investment Bond, therefore, allows one to avoid the risk that the policies will be brought to a premature end by the death of all of the lives assured.

Investment Units and the Policy Value

1.14 Both types of policy are conventional unit-linked policies. That is, a "Policy Value" is calculated from time to time by reference to a segregated group of the company's assets which are accounted for as units. The premia paid under the policies are notionally invested in these units.

Surrender Benefits

1.15 Under both types of policies the policyholder from time to time is able to surrender the policies in whole or in part subject only to some restrictions to prevent surrenders which would leave very small policies in existence. On full surrender an amount is paid to the Policyholder equal to the Policy Value. On a partial surrender a proportionate amount of the Policy Value is paid.

Withdrawal Benefits

1.16 The Policyholder may specify a pattern of regular withdrawals expressed as periodic monetary sums. It is possible to specify intervals of three, six, nine or twelve months for the payment of regular withdrawals and to defer the first payment for up to five years. The withdrawals can either be of a level monetary amount or may be increased by a

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fixed percentage. Annual withdrawals of one to five per cent of the total premia can be increased at annual rates of up to ten per cent per year.

Maturity Benefits

1.17 Under the collective investment bond the maturity benefit paid on the death of the last of the lives insured is one hundred and one per cent of the Policy Value. Under the Collective Redemption Bond the maturity benefit will be the higher of the Policy Value and twice the total premia paid under the policies.

Repayment of the Loan

1.18 Because the loan is repayable on demand, the Lender can specify any pattern of repayments which he wishes, either in advance or from time to time. He might, for example, decide to take a regular series of repayments such as an amount equal to five per cent of the loan annually. He might decide only to take payments as and when he requires them. He might decide that he doesn't need any repayments but wants to be able to draw on the loan in an emergency or on an unforeseen change of circumstances. In the last case it may be that when the Arrangement has run for some time he will feel that he does not need to continue to have recourse to the full amount of the loan and so might waive some part or parts of the loan at that time. If he does this, it will be necessary to do so under deed or the waiver will be ineffective.

1.19 The trustees will fund the repayments of the loan by making full or partial surrenders of the policies.

1.20 On the death of the Lender, the outstanding loan will be an asset of his estate unless he has previously alienated his beneficial ownership of it.

Example

John Michelin is seventy years old and is married to Margaret, who is sixty. They have three children; two sons, Harvey (35) and Harry (30) and a daughter, Dove (16).

The Arrangement is made

In order to leave room for substantial further growth John enters into the Arrangement six times on the 1st, 2nd, 3rd, 4th, 5 and 6th July 2009. On each occasion he uses the Manx Discretionary Trust Deed, he lends £250,000 and the trustees (the "Arrangement Trustees") invest the moneys loaned to them in a Collective Redemption Bond. The Arrangement Trustees are himself, his solicitor and his accountant.

He has substantial other assets so he expects to call on the loans only in extremis.

Part of the Loans are Written Off

On the 30th July 2012, on his seventy fourth birthday, he decides he can safely waive £45,000 of each of the loans and does so under deed.

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The Death of John Michelin

He dies on the 30th June 2018, aged seventy nine. Under his Will, the loans due from the Arrangement Trustees are to be held on life interest trusts (the "Will Trusts") for his wife Margaret. At that time the aggregate of the outstanding principal amounts under the loans is £1,230,000 ((£250,000 - £45,000) x 6). The aggregate Policy Values of the policies in the six settlements are £2,322,000 (being £387,000 per Bond).

The Advance of the Loans

On the 31st August 2018 the trustees of the Will Trusts use an overriding power over capital to advance loans to Harvey, Harry and Dove, two loans being advanced to each.

The Decennial of the Arrangement Trusts

At the beginning of July 2019 the policies in each Arrangement Trust have a surrender value of £410,000.

The Advance of the Policies

On the 30th September 2019 the policies in each trust have aggregate Policy Values of £420,000. On that day the trustees of each of the six trusts advance the policies to that beneficiary who held the loan due from the trust concerned in consideration of the loan being treated as discharged.

The Surrender of the Policies

Each of the three beneficiaries then surrenders the policies immediately receiving £840,000 (£420,000 x 2) each.

Mrs Michelin is alive on 31st August 2025.

None of the dramatis personae have made any transfers of value which are not recorded above and all have been, and are, in all relevant periods, resident and ordinarily resident in the United Kingdom and domiciled in England except that Dove was neither resident nor ordinarily resident in the United Kingdom in 2019/2020.

It is assumed that all tax laws, rates, allowances et cetera are unchanged except that in all years the top rate of Income Tax is fifty per cent and the Inheritance Tax Nil-Rate Band is £350,000.

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THE ARRANGEMENT IS MADE

Inheritance Tax

A Disposition

2.1 When Mr Michelin enters into the trust deed he makes a disposition of his property.

A Transfer of Value?

2.2 That disposition will be a transfer of value if it results in the value of his estate immediately after the disposition being less than it would be but for the disposition. In his Opinion on the Arrangement, Counsel concludes that there is no transfer of value within the meaning of s.3 because the making of the loan does not diminish the value of the settlor's estate. He reaches this conclusion on the basis that before the Lender makes the loan his estate includes the money which is to be lent and after he has made the loan it includes the chose in action, or right to be paid the amounts lent. That assumes that these two assets, the money and the right of repayment, are of equal value. Is that a realistic assumption?

2.3 Section 160 provides that:-

> "Except as otherwise provided by this Act, the value at any time of any property shall for the purposes of this Act be the price which the property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time."

2.4 In respect of a right to receive a sum due under any obligation, however, this general rule is modified by s.166 which provides that:-

> "In determining the value of a right to receive a sum due under any obligation it shall be assumed that the obligation will be duly discharged, except if or to the extent that recovery of the sum is impossible or not reasonably practicable and has not become so by any act or omission of the person to whom the sum is due."

2.5 The Lender's right to repayment of the loan is unsecured, interest free and repayable on written notice. It is likely that immediately after the Collective Redemption Bond is taken out its surrender value will be less than the amount of the loan because of the insurance company's charges made against the unit value on which the policy value is determined. What price could one expect to obtain if one sold the repayment right in the open market? At the current time, it is practically impossible to receive a secured loan from a commercial lender, the principal of which is equal to the value of the asset on which it is secured. So it is highly unlikely that any purchaser in the market would be

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willing to pay an amount equal to the loan principal for the repayment right which is unsecured.

2.6 What effect does s.167 have on this? One might argue that that section applies so that one must assume, in arriving at the market price which would be paid for the repayment right, that there is no credit risk attaching to it. Even if that is correct, that does not mean that a purchaser of the repayment right would pay the full amount of its face value. There would be costs of time and advice in evaluating the loan and arriving at the purchase price. There is no point in purchasing a loan for the amount of money which is repaid under the loan. What is more, the loan bears no interest and written notice must be given to the lender. It is implicit in the terms of the loan, that the Lender must have a reasonable time to respond to that notice and to repay the loan. So, a purchaser would inevitably hold the repayment right for a few days before he could obtain repayment during which time no interest would be earned. So even if s.167 has the result that one ignores credit risk, valuing the repayment right in accordance with s.160 will mean that it will be valued at less than the amount of the principal of the loan.

2.7 In respect of our example, we will assume that the effect of s.166 is that in valuing Mr Michelin's rights under the loans it is to be assumed that they bear no credit risk but that, for the reasons explained, a purchaser would not be willing to pay an amount equal to the amount repayable under the loan. For the sake of illustration, we arbitrarily assume that a purchaser would be willing to pay ninety five per cent of the principal of the loans for the repayment rights and that, therefore, the Lender will make a transfer of value of £12,500[4] on entering into each Arrangement.

A Chargeable Transfer

2.8 The transfer of value occurring by reason of making the loan 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.[5]

2.9 It will be a chargeable transfer unless it is exempt under any provision.[6] 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."

---

4 Except that the chargeable transfer under the first loan will be reduced by the annual exemptions (under s.19) for 2008/2009 and 2009/2010

5 Section 3A

6 Section 2

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2.10 For this purpose a 'transaction' includes a series of transactions and any associated operations.[7]

2.11 It is clear that the loan to the persons who are to be trustees and the creation of the trusts are a series of transactions (and they are also, of course, associated operations) and, therefore, that the transaction to be considered for the purposes of applying s.10(1) is a composite transaction which includes the making of the loan and the declaration of trusts over the loan proceeds. That being the case, the transfer of value does not satisfy the condition that it "… was not made in a transaction intended to confer any gratuitous benefit on any person". So the transfer of value will be an immediately chargeable transfer.

2.12 Mr Michelin, therefore, makes a chargeable transfer of £12,500 per day on each day from the 1st July 2009 to the 6th July 2009 except that the transfer on 1st July is reduced to £6,500 (£12,500 - £3,000 - £3,000) by the annual exemptions for 2008/2009 and 2009/2010.[8] As he has made no previous transfers of value these chargeable transfers will be charged at nil per cent because they are within the Nil-Rate Band.[9]

Capital Gains Tax

2.13 There will be no disposal by either Mr Michelin or the trustees when the Arrangement is made.

Income Tax

The Pre-Owned Assets Charge

2.14 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 paragraph 8 provides 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

7 Section 10
8 Section 19
9 Section 7

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(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."

2.15 It will be seen that 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. Because Mr Michelin is excluded from benefitting under the settlement this condition will not be satisfied and so the charge will not apply.[10]

PART OF THE LOANS ARE WRITTEN OFF

Inheritance Tax

3.1 The waiver of parts of the loans will be a transfer of value. It is therefore necessary to value the loans immediately before and after the waiver. We assume, for the reasons explained in paras 2.2.1 – 2.2.6 that the market value of the loan would continue to be ninety five per cent of the amount payable under it. The Inheritance Tax calculation on the waiver would therefore be:-

	£
Value of six loans of £250,000 £250,000 x 6 x 95%	1,425,000
Value of six loans of £205,000 (£250,000 - £45,000) £205,000 x 6 x 95%	<1,168,500>
Annual exemptions for 2011/2012 and 2012/2013	<6,000>
	250,500
Chargeable transfers within previous seven years (6 x (£250,000 – £237,500)) - £3,000 - £3,000	69,000
Aggregate transfers within Nil-Rate Band	£319,500

3.2 So no Inheritance Tax will be chargeable.

Capital Gains Tax

3.3 TCGA 1992 s.251(1) provides that:-

[10] ITTOIA 2005 s.624(1) and s.625

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> "Where a person incurs a debt to another, whether in sterling or in some other currency, no chargeable gain shall accrue to that (that is the original) creditor or his personal representative or legatee on a disposal of the debt, except in the case of the debt on a security (as defined in section 132)."

3.4 So no gain will accrue on Mr Michelin's rights under the loan unless they constitute a debt on a security. A debt on a security is an obscure concept. It is clear, however, that where, as here, a debt yields no interest and has no premium on redemption it is not a debt on a security and HMRC accept that that is so.[11]

3.5 So no gain will arise on the Lender's waiver of his rights to repayment under the loans.

<u>Income Tax</u>

3.6 No Income Tax charge will arise by reason of the waiver.

<u>THE DEATH OF JOHN MICHELIN</u>

<u>Inheritance Tax</u>

Charge on Death

4.1 On the death of any person tax is charged as if immediately before his death he had made a transfer of value, the value of which was equal to the value of his estate immediately before his death.[12]

Chargeable Transfers within Seven Years of Death

4.2 Because they were made more than seven years before his death, the chargeable transfers made by Mr Michelin on entering into the Arrangement in 2009 will not be taken into his cumulative transfers in calculating the tax chargeable under s.4. We have seen that the write off of the loans was a chargeable transfer to the extent that it was not covered by the annual exemptions for 2011/2012 and 2012/2013 but that it was charged at nil per cent because it fell within Mr Michelin's Nil-Rate Band. Because Mr Michelin died within seven years of that chargeable transfer its amount will increase the prior chargeable transfers taken into account in calculating Inheritance Tax on Mr Michelin's death. It will utilise £264,000 ((£45,000 x 6) - £3,000 - £3,000) of the Nil-Rate Band.

Spouse Exemption

4.3 It is generally accepted that the exemption for transfers between spouses under s.18 will apply to the deemed transfer immediately before death arising under s.4 if the property concerned devolves on the spouse on the death. The technical basis for this is obscure but it seems to have been accepted since the inception of Capital Transfer Tax. The

[11] Capital Gains Tax Manual para 53426
[12] Section 4

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interest in possession for Margaret Michelin arising under the Will will be an immediate post-death interest.[13] Mrs Michelin will therefore be treated as being beneficially entitled to the property in which the interest subsists.[14] The value charged under s.4, therefore, will not include the value of the loans because they will be treated as exempt under the spouse exemption.

Gifts with Reservation

4.4 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."

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[13] Section 49A

[14] Section 49

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

4.6 Counsel, in his Opinion on the strategy, considers it quite clear that the settlor, in entering into the Arrangement, has not made a gift because, he says, a loan is not a gift but the very opposite of a gift. For FA 1986 s.102 to apply there must be a disposal of property "by way of gift." There is certainly a disposal of property. Mr Michelin disposes of the moneys which he advances to the trustees. More precisely, under the clearing system he agrees to reduce the debt owed to him by his bankers (represented by the balance on his bank account) in consideration of his banker's acknowledging a debt due to the Company's bankers. That is clearly a disposal of a part of a chose in action, being the debt due from his bankers. Is it a disposal "by way of gift"?

4.7 It is clear that, in its everyday usage, a 'gift' would not normally include the making of a loan whatever its terms. The *Concise Oxford Dictionary* Fifth Edition gives a variety of meanings of gift of which the most apposite is a "voluntary transfer of property without consideration". It is accepted, however, that "gift" in FA 1986 s.102 must have a more extended meaning than this. No one denies, for example, that if I were to sell my house to my daughter for one pound and to continue to live in it, I would have reserved a benefit in the property just as if I had given it to her for no consideration. In *Inland Revenue Commissioners v Eversden and Another* [2003] EWCA Civ 668 Lord Justice Carnwath said:-[15]

> "Rightly or wrongly (from the purist's point of view), the draftsmen clearly did find it possible to equate a disposal by way of gift with a transfer of value. That is the effect of posing, in the sub-section, the question whether the disposal by way of gift "is an exempt transfer", with specific reference to the provisions of Part II of the 1984 Act all of which are references to "transfers of value" ...
>
> If further support were needed for this view that the draftsmen of the 1986 Act did not share …[Counsel for IRC's]… conceptual problems, it may perhaps be found in IHTA s.3A (see above), as inserted by the 1986 Act, dealing with "potentially exempt transfers". Such a transfer is defined as "a transfer of value," subject to certain conditions, "to the extent that it constitutes ... a gift to another individual..." By sub-section (2), a transfer of value is regarded as a gift for these purposes to the extent that either (a) "the value transferred is attributable to property which ... becomes comprised in the estate of that other individual", or (b) "to the extent that, by virtue of the transfer, the estate of that other individual is increased." Although (b) may be seen as an extension of the normal meaning of "gift", (a) is wholly consistent with the interpretation which I would regard as the natural reading of s 102(5), and shows no difficulty in marrying the two concepts. Although the relationship is not spelt out in s 102(5) in the same detail, it would be surprising if the draftsman was intending to use the term "gift" in a radically different sense in two places in the same Act."

[15] At paras 22 and 23 ibid

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4.8 This is not to say that the meaning of "gift" in s.102 is co-extensive with that of a transfer of value which is within s.3A(c). As the authors of *M^c^Cutcheon on Inheritance Tax*[16] say, "there are cases where a gift will not amount to a transfer of value and vice versa". Under Estate Duty it appears that to rank as a gift a disposition had to contain some element of bounty.[17] The authors of *McCutcheon* then adopt that rule in concluding that a sale of an asset at an intentional undervalue will constitute a gift within the reservation of benefit rules.[18] In relation to interest free loans, however, the authors of *McCutcheon* say:-

> "In the authors' view a loan at less than a commercial rate of interest does not of itself constitute a gift with reservation. It is true that when a person lends money or other property otherwise than on commercial terms he thereby makes a gift, but only of the interest foregone. No benefit is retained by the donor in that foregone interest. There is no gift of the capital lent, and therefore s.102 (which requires a disposal by way of gift to have been made) cannot bite on it. HMRC appear to agree with this analysis."

4.9 It is certainly true that "a loan at less than the commercial rate of interest does not of itself constitute a gift with reservation". That is not to say, however, that such a loan in the context of a set of arrangements with a bounteous purpose could not do so. The requirement of s.102 is not that the disposal should be a gift but rather should be "by way of gift". If the distinguishing mark of a gift is that it carries an element of bounty we can see no reason why the transfer of moneys under an interest free loan which is made on terms designed to convey bounty on another person should not be said to be made by way of gift. At the least, in the absence of direct case authority, it is clear that here there is an uncertainty in respect of the fundamental mechanism by which the Arrangement is intended to work.

4.10 The author's understanding is that HMRC have not, in practice, challenged loan trust schemes on the basis that there is a reservation of benefit. Paragraph 14137 of the Capital Gains Tax Manual says:-

> "The grant of an interest free loan repayable on demand -
>
> - is not a transfer of value (because the value of the loan is equal to the amount of it)
> - but it is a gift because there is a clear intention to confer bounty: the property disposed of is the interest foregone.
>
> The grant of such a loan is not, in itself, a GWR.

---

16 *McCutcheon on Inheritance* Tax Fifth Edition (published by Sweet & Maxwell) at page 237

17 *AG (I) v Smith* (1905) 2 Ir.R 533; *HM Adv v Heywood-Lonsdale's Trustees* (1906) 43 SLR 529; Re *Fitzwilliam's (Earl) Agreement* [1950] Ch 448; *Re D'Avigdor-Goldsmid* [1953] AC 347

18 *McCutcheon on Inheritance* Tax Fifth Edition (published by Sweet & Maxwell) at page 238

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There is however a special provision relating to loans to settlements which is mentioned later in this section."[19]

4.11 This passage does not provide great comfort. One can only agree that the grant of an interest free loan repayable on demand is not, in itself, a GWR. The passage begs the question, in what circumstances will it be a gift with reservation?

FA 1986 Schedule 20 Para 5(4)

4.12 FA 1986 Sch 20 paras 5(3) and (4) provides that:-

> "(3) Where property comprised in a gift does not become settled property by virtue of the gift, but is before the material date settled by the donee, sub-paragraphs (1) and (2) above shall apply in relation to property comprised in the settlement as if the settlement had been made by the gift; and for this purpose property which becomes settled property under any testamentary disposition of the donee or on his intestacy (or partial intestacy) shall be treated as settled by him.
>
> (4) Where property comprised in a gift becomes settled property either by virtue of the gift or as mentioned in sub-paragraph (3) above, any property which -
>
> (a) on the material date is comprised in the settlement, and
>
> (b) is derived, directly or indirectly, from a loan made by the donor to the trustees of the settlement,
>
> shall be treated for the purposes of sub-paragraph (1) above as derived from property originally comprised in the gift."

4.13 One might argue that if the loan is not itself a gift, there is no gift involved in the Arrangement because it is a condition of the loan being made that the trustees will hold the moneys paid under the loan on the Arrangement Trusts. That in itself would be a very surprising conclusion as it is clear that the discretionary objects of the Arrangement Trusts have been gratuitously benefitted by the Arrangement and that that was the purpose of those arrangements. The argument might be modified, therefore, to say that although there is a gift, the Lender is not the donor of that gift and therefore the condition of sub-paragraph 4(b) ibid is not satisfied. Again, however, that would be a very surprising conclusion. The loan is made to the trustees by the Lender on condition that the moneys lent under the loan will be settled on the Arrangement Trusts.

4.14 Once again it seems to the author that it is, at the least, arguable that FA 1986 Sch 20 paras 3 and 4 will apply to treat the moneys paid under the loan as property subject to a reservation in respect of a disposal of those moneys by the Lender by way of gift.

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[19] This refers to FA 1986 Sch 20 para 5(4) which is considered at para 2.4.12 *ff* below

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4.15 If that is the case, the gift with reservation provisions will apply to the property comprised in the settlement.[20]

FA 1986 Schedule 20 Para 7

4.16 FA 1986 Sch 20 para 7 provides that:-

> "(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),
>
> (c) 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."

4.17 This provision does not apply to Mr Michelin's Arrangement because a capital redemption policy such as the Collective Redemption Bond is not a policy of life insurance. Even if Mr Michelin had used a Collective Investment Bond, para 7 would still not have applied because, under the Arrangement, where that bond is used, it is written on lives other than those of the Lender or his spouse. In any event, the condition of sub-paragraph 1(b) is not satisfied in respect of the Arrangement.

Capital Gains Tax

4.18 Under TCGA 1992 s.62(1) the assets of which a deceased person was competent to dispose at his death are deemed to be acquired by his personal representatives for a consideration equal to their market value but, in spite of this deemed acquisition, they are not deemed to have been disposed by him at his death. In any event even if the loans were treated as having been the subject of a disposal at death no chargeable gain or allowable loss would arise.[21]

Income Tax

4.19 Because Mr Michelin's death is not an event leading to a benefit under the policies becoming payable it is not a chargeable event.

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[20] FA 1986 Sch 20 para 5(1)
[21] TCGA 1992 s.251

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The Overall Effect of Mr Michelin's Death

4.20 Provided that Mr Michelin has not reserved a benefit in the property which is subject to the Arrangement Trusts, he has managed to pass assets for the benefit of his children with a total value of £1,092,000 (£2,322,000 - £1,230,000).

THE ADVANCE OF THE LOANS

Inheritance Tax

5.1 Because Mrs Michelin was treated as the beneficial owner of the property in which her interest in possession subsisted[22] she is treated as making potentially exempt transfers to Harvey, Harry and Dove. Because she survives the gifts by at least seven years they prove not to be chargeable transfers.[23]

Capital Gains Tax

5.2 No chargeable gain or allowable loss arises on the advance of the loans.[24]

Income Tax

5.3 No Income Tax charge will arise by virtue of the advance.

THE DECENNIAL OF THE ARRANGEMENT TRUSTS

Inheritance Tax

Section 66

6.1 On the first decennial of the settlement a charge under s.64 will arise. Under s.66 that charge is at three tenths of the effective rate. The effective rate is found by reference to a hypothetical transfer. That hypothetical transfer is first calculated under IHTA 1984 s.66(3) – (5).[25]

---

[22] Section 49

[23] Section 3A

[24] TCGA 1992 s.251

[25] Section 66(2) reduces the rate at which tax is charged where "the whole or part of the value of the relevant property in the settlement is attributable to property which was not relevant property, or was not comprised in the settlement, throughout the period of ten years immediately before the ten year anniversary concerned." One might think that this applies to the Arrangement Trust because the write off of the loans increased the value of the settled property. That is not the case, however, because all of the property in the settlement has been comprised in the settlement throughout the settlement's existence and has been relevant property in relation to that settlement

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	1 £	2 £	3 £	4 £	5 £	6 £
Hypothetical value transferred determined under sub-section (4)						
Value of relevant property (£410,000 - £205,000)	205,000	205,000	205,000	205,000	205,000	205,000
Value of property in related settlement immediately after it commenced	0	0	0	0	0	0
	205,000	205,000	205,000	205,000	205,000	205,000
Hypothetical prior chargeable transfers determined under sub-section (5)						
Value transferred by settlor ending with the day on which the settlement commenced[26]	0	10,000	20,000	30,000	40,000	50,000
Deemed transfer is within Nil-Rate Band	205,000	215,000	225,000	235,000	245,000	255,000

Section 67

6.2 Section 67 applies where, after a settlement commences but before the decennial concerned, the settlor has made a chargeable transfer as a result of which the value of the property comprised in the settlement was increased.

6.3 Section 67 applies because the settlor has made a chargeable transfer in respect of each settlement (the loan waivers) as a result of which the value of the property comprised in the settlement was increased. Where s.67 applies one has to make an alternative calculation in which the hypothetical prior chargeable transfers determined under sub-section (5) are recalculated using the values transferred by the chargeable transfer made by the settlor in the period of seven years ending with the day on which the addition took place but disregarding transfers made on that day and excluding the value of any property which is taken into account under s.66(4) in determining the hypothetical value transferred.

6.4 That means that the hypothetical prior transfers of the settlor will include, in respect of each settlement, all of the value transferred on the making of the other settlements but not of the settlement concerned. Thus, the hypothetical prior transfers in the calculation above will increase to £50,000 per settlement. Even with this adjustment the deemed transfer taken into account in calculating the decennial charge for each settlement will be within the Nil-Rate Band. So the effective rate will be nil per cent and the rate at which tax is charged under s.64 will, therefore, also be nil per cent.

<u>Income Tax and Capital Gains Tax</u>

6.5 The occurrence of the decennial of the settlement is of no relevance to Income Tax or Capital Gains Tax.

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[26] Mr Michelin is regarded as the settlor for Inheritance Tax purposes under s.44

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THE ADVANCE OF THE POLICIES

Inheritance Tax

The Advance by the Trustees

7.1 The advance of the policies in consideration of the discharge of the loans will be an occasion of charge under s.65 because the property comprised in the settlements will cease to be relevant property. The value on which tax is charged will be the amount by which the value of the relevant property comprised in the settlement is less immediately after the event than it would be but for the event. As the trusts are brought to an end by the advance the value on which tax will be charged will be the net value of the property in the Arrangement Trusts. That is, £215,000 ((£420,000 - £205,000)) in respect of each trust. The rate at which tax is charged is calculated by reference to the rate at which tax was charged on the previous decennial. The rate will therefore be nought per cent and no charge will arise on the advance of the policies.

The Waiver of the Loans

7.2 As the value of the beneficiaries' estates will be increased by the transaction it will not be a transfer of value by them.

Capital Gains Tax

The Advance by the Trustees

7.3 A gain accruing on a disposal of, or of an interest in, the rights conferred by a capital redemption policy is not a chargeable gain[27] and a loss is not an allowable loss.[28]

The Waiver of the Loans

7.4 The extinction of an asset is a disposal of it for the purpose of Capital Gains Tax[29] and therefore the waiver of the loans will be a disposal of those loans by the beneficiaries concerned. Section 251 will not apply to exempt any gain arising because the beneficiaries were not the original creditor and did not acquire the loan as personal representatives or as legatee. The transactions by which the loans were acquired and waived were not transactions at arms length and so the beneficiaries will be deemed to have both disposed of, and acquired, the loans for their market value at the time of the disposal and acquisition.[30] Unless there has been a significant change in the value of the policies or in the solvency of the trustees concerned between the disposal and acquisition it is likely that any gain on the disposal of the loans will be small.

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[27] TCGA 1992 s.204
[28] Section 16 ibid
[29] TCGA 1992 s.24
[30] TCGA 1992 s.17

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Income Tax

7.5 An assignment of all of the rights under a policy for money or moneys worth is a chargeable event.[31] The policies have been assigned by the trustees for consideration consisting of an agreement to discharge the loans.

7.6 The calculation of the chargeable event gain arising in each trust will be as follows:-[32]

	£
TB = the amount or value of the consideration for the assignment	205,000
TD = premium paid	250,000
PG = prior chargeable event gain	0
Chargeable event gain	0

The excess of the aggregate of TD and PG over TB will not be relieved.[33]

THE SURRENDER OF THE POLICIES

Inheritance Tax

8.1 The surrender of the policies does not reduce the value of the beneficiaries' estates and so it is not a transfer of value.

Capital Gains Tax

8.2 A gain accruing on a disposal of, or of an interest in, the rights conferred by a capital redemption policy is not a chargeable gain[34] and a loss is not an allowable loss.[35]

Income Tax

8.3 The surrender of the policies is a chargeable event.[36] The chargeable event gain arising will be calculated as follows:-[37]

---

31 ITTOIA 2005 s.484(1)(a)(ii)
32 Strictly, the chargeable gains ought to be calculated in relation to each policy but for simplicity the calculation is made in relation to the policies held by each trust
33 ITTOIA 2005 s.539
34 TCGA 1992 s.204
35 Section 16 ibid
36 ITTOIA 2005 s.484(1)(a)(i)
37 The calculation strictly should be made for each individual policy but for the sake of simplicity the calculation is done for all of the policies owned by an individual beneficiary

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	£	£
TB = the sum payable because of the event (£420,000 x 2)		840,000
TD = total value of consideration given for the last assignment for consideration (£205,000 x 2)	410,000	
Total premia paid after last such assignment	0	
		410,000
Chargeable event gain		430,000

8.4 It will be seen that the total chargeable event gains assessed in respect of each Bond are £215,000 (£430,000 ÷ 2) but the actual economic profit over the life of the Bond is £170,000 (£420,000 - £250,000). The difference of £45,000 represents the excess of the premia paid under the bond over the consideration for which the Bond was assigned by the trustees to the beneficiary. That is because there is no deficiency relief in respect of the deficiencies arising to the trustees.[38]

AN OVERVIEW OF THE ARRANGEMENT

9.1 If it is successful, the Arrangement allows the Lender to continue to draw on the amount originally placed in the Arrangement whilst ensuring that the investment yield on that amount is outside his estate for Inheritance Tax purposes. The Arrangement does not require the settled funds to be invested in a policy and its advantages are not specific to insurance or capital redemption policies. The capital redemption policy is undoubtedly administratively convenient and the costs of establishing the structure will be reduced by using the insurance company's standard documentation. Nonetheless, it would be imprudent to place substantial funds in such a structure without having the insurance company's documentation independently reviewed.

9.2 The success of the strategy is entirely dependent upon there being no disposal by way of gift under the Arrangement of property subject to a reservation. In our view, it is at least arguable that there is such a reservation of benefit. It appears that at the moment HMRC do not take this point. It should be noted that paragraph 20501 of the Inheritance Tax Manual considers the former versions of these strategies, which FA 1986 Sch 20 para 5(4) was designed to frustrate, and explains that:-

> "it was considered unreasonable for individuals to limit their estates in such artificial ways, and legislative changes were introduced to counteract them."

[38] ITTOIA 2005 s.539

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9.3 At paragraph 20513 headed “revised schemes following legislative changes” the Manual merely says “this text has been withheld because of exemptions in the Freedom of Information Act 2000”.

9.4 That would seem to indicate that HMRC regards such schemes as tax avoidance schemes to be frustrated if that is possible and that they wish to keep secret their analysis of current versions of the scheme.

DISCOUNTED GIFT TRUSTS

THE ARRANGEMENT

Introduction

10.1 Discounted gift trusts have been in existence for many years and are offered by most of the insurance companies in the Inheritance Tax planning market. In this lecture we examine the arrangement (the “Arrangement”) offered by Royal Skandia Life Assurance Limited (the “Company”), a company registered and resident in the Isle of Man.

Information Supplied

10.2 The Company has been very helpful in providing a package of information concerning the bond which includes Counsel’s Opinion on the arrangement, Instructions to Counsel, four different standard Trust Deeds for use in the Arrangement and a variety of information sheets which are given to advisers and their clients including sheets giving the key features of the collective redemption bond[39] and the collective investment bond[40] used in the Arrangement.

Entering into the Arrangement

10.3 A person (the “Donor”) wishing to enter into the Arrangement applies for a bond which is a collection of policies of one of two types.[41] The number of policies within the bond is either as specified by the Donor in his application or, by default, ten. The company will not accept applications from donors who will be ninety years old or more at their next birthday.[42]

The Policies

10.4 Two different types of policies may be used under the Arrangement. First, a “Collective Redemption Bond” which is a bond intended to be a capital redemption policy within ITTOIA 2005 s.473(2) which matures ninety nine years after issue. Secondly, a “Collective Investment Bond” which is a whole of life insurance policy written on multiple lives assured (who should not include the Donor or his spouse) and which

[39] See paras 3.1.4 and 3.1.5 below
[40] See para 3.1.4 below
[41] See para 3.1.4 below
[42] Due to the decision in *HMRC v Bower & Another (Executors of Bower (Deceased))* 2008 EWHC 3105 (Ch)

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matures on the death of the last of the lives assured to die. It is not expected that either type of policy will be maintained until its maturity date.

The Lives Assured

10.5 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 policyholders the Policies under the Arrangement are written on joint or multiple lives. Even so, having multiple lives assured does require one to choose suitable people. If too many are chosen, it may be inconvenient to keep track of them. If only a small number are used, there is a risk that their unexpectedly early death may bring the Arrangement to a premature end. The Collective Redemption Bond, as a Capital Redemption Policy, does not have a life assured but matures on a fixed date. Using a Collective Redemption Bond rather than a Collective Investment Bond, therefore, allows one to avoid the risk that the policies will be brought to a premature end by the death of all of the lives assured.

Investment Units and the Policy Value

10.6 Both types of policy are conventional unit-linked policies. That is, a "Policy Value" is calculated from time to time by reference to a segregated group of the company's assets which are accounted for as units. The premia paid under the policies are notionally invested in these units.

Surrender Benefits

10.7 Under both types of policies the policyholder from time to time is able to surrender the policies in whole or in part subject only to some restrictions to prevent surrenders which would leave very small policies in existence. On full surrender an amount is paid to the Policyholder equal to the Policy Value. On a partial surrender a proportionate amount of the Policy Value is paid.

Withdrawal Benefits

10.8 The Policyholder may specify a pattern of regular withdrawals expressed as periodic monetary sums. It is possible to specify intervals of three, six, nine or twelve months for the payment of regular withdrawals and to defer the first payment for up to five years. The withdrawals can either be of a level monetary amount or may be increased by a fixed percentage. Annual withdrawals of one to five per cent of the total premia can be increased at annual rates of up to ten per cent per year. Under the policy terms there is no limit, other than the Policy Value, on the amount of the first Regular Withdrawal. The Company will not accept applications for Bonds, however, where the amount of the

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first Regular Withdrawal is set at more than fifteen per cent of the total premia paid under the Bond.

Maturity Benefits

10.9 Under the collective investment bond the maturity benefit paid on the death of the last of the lives insured is one hundred and one per cent of the Policy Value. Under the Collective Redemption Bond the maturity benefit will be the higher of the Policy Value and twice the total premia paid under the policies.

The Trusts

The Trust Deed

10.10 At the same time that the Donor completes an application form for the policy he also completes a trust deed.[43] Under the trust deed Skandia is authorised to insert a date in the deed which is the date on which the trusts are to come into effect and it will do so at the time that it issues the policy. Thus the trust deed is signed in escrow by the Donor and the trust comes into effect when the deed is dated by Skandia. The trust provides that the trustees are to hold the "Settlor's Fund" on bare trust for the settlor. The Settlor's Fund is to consist of "the contractual right to receive regular withdrawals as specified in the policy terms and conditions applicable to" the policies which are subjected to the trusts.

The Withdrawal Form

10.11 Also, at the same time, the persons who are to be trustees under the trust complete a 'withdrawal form' which is an instruction to the company to pay regular withdrawals. The instruction defines the amount and frequency of the regular withdrawals by reference to Schedule 3 of the Settlement in which is set out a pattern of regular payments which are to be made to the settlor (the Donor) from the Settlor's Fund and which are to cease on the Donor's death.

The Settlor's Fund

10.12 One might think, therefore, that the Settlor's Fund consists only of the right to regular withdrawals equal to the payments listed in Schedule 3 in respect of which an instruction is given by the trustees under the Withdrawal Form. As we have seen, however, the Settlor's Fund means "the contractual right to receive regular withdrawals as specified in the policy terms and conditions applicable" to the policies subject to the trust. So if, subsequent to the Arrangement commencing, the trustees were to exercise their contractual right against the Company to require additional regular withdrawals the right to those withdrawals would be an asset of the Settlor's Fund.

[43] There are four standard versions; there are two versions written under English Law and two under Manx Law providing for a bare trust of the residual fund under one version and a discretionary trust of the residual fund under another. See para 3.1.16 below

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10.13 The company's explanatory material says that it is not possible for the pattern of withdrawals to be altered once it has been set. This is subject to the Donor's ability to alienate his right to any one or more regular withdrawal amounts by deed. The trustees, however, have a contractual right against the company to exercise their surrender and withdrawal rights at any time and, indeed, they may well do so after the death of the Donor. Whilst the Donor is alive, however, it is arguable that their duty as trustee would prevent them from doing so because, were they to do so, they would favour one beneficiary under the settlement at the expense of the others.

10.14 There is a counter argument that the "contractual right to receive regular withdrawals" includes the right to require the company to make regular withdrawal payments. If that were the case, the trustees would hold the right for the Donor beneficially and the Donor would have the power to require the trustees to exercise the right. The Donor's omission to do so would itself be a transfer of value and the Arrangement would not achieve its purpose.

10.15 The better view would seem to be that the "the contractual right to receive regular withdrawals" does not arise until the Policyholder has exercised the right to require the company to make regular withdrawal payments and that the latter right is not an asset of the Settlor's Fund.

The Two Forms of Trust

10.16 There are two forms of standard trust. Under the first, the residual fund is held for persons named in a schedule to the trust deed in the proportions set out in that schedule. The second form of trust creates a discretionary trust for a discretionary class defined in the trust deed. The class will be determined by the Donor in completing the Trust Deed.

The issue of the policies and creation of the trust

10.17 When the application form, the trust deed and the withdrawal form have been completed they are submitted to the Company which issues the policy and dates the trust deed simultaneously with the result that on issue the contractual terms of the policy will include the payment of regular withdrawals in accordance with the pattern set out in the Trust Deed and the policy will be subjected to the trusts of that Deed ab initio.

10.18 In this lecture we illustrate the tax effects of the Arrangement by reference to the example below. The use of the discretionary form of trust is appropriate only for small gifts[44] so the example concerns a donor opting to create a bare trust in the Residual Fund.

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[44] Because, where a discretionary trusts is used, the transfer of value arising when the Arrangement is made would be an immediately chargeable transfer (sections 3 and 3A - all statutory references in this lecture are to the Inheritance Tax Act 1984 unless otherwise stated)

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Example

Captain Broad is a widower and was seventy years old on 30th June 2009.

The Arrangement is Made

He entered into the Arrangement paying a premium of £1,000,000 into a Collective Redemption Bond. He completed the bare trust version of the standard trust deed providing that the Residual Fund was to be held for his two sons, Longstem and Sercombe, in equal shares. He specified annual withdrawals to start in five years time, starting at £25,000 (that is, two and a half per cent of the premium) and increasing by ten per cent per annum.

The trustees were Captain Broad, Longstem and Sercombe.

The Policy Application, Trust Deed and Withdrawal Form were received by the Company which then issued the Bond and dated the trust on the 30th June 2009.

The market value of his retained rights on the 30th June 2009 was £304,815.

Captain Broad settles his right to the first three withdrawals

On the 31st May in each of the first three years that the regular withdrawal payments are payable, Captain Broad enters into deeds providing that the right to the withdrawal concerned is to be held on the trusts of the Residual Fund. This results in the following amounts being added to the Residual Fund:-

30th June	£
2014	25,000
2015	27,500
2016	30,250

The first three regular withdrawal payments are received by the trustees from the Company on the trusts of the Residual Fund.

The Regular Withdrawal Benefits are received by the trustees and an equal amount is paid to Captain Broad

Thereafter he retains his rights to the regular withdrawal payments. The trustees make payments to him equal to the regular withdrawal payments made by the Company to them. He receives the following amounts:-

30th June	£
2017	33,275
2018	36,603
2019	40,263
2020	44,289

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Captain Broad Dies
Captain Broad is diagnosed with a terminal disease on the 31st May 2020 and his life expectancy is estimated at that time as three months. He dies on the 31st July of that year. The Policy Value at his death is £1,545,000 and the assets deriving from the Regular Withdrawal Rights settled on the Residual Fund by Capital Broad now have a value of £110,000.

The Policies are Surrendered
A couple of weeks after Captain Broad's death the trustees advance the trust assets to Longstem and Sercombe, exercising their power of appropriation to advance an equal number of whole policies to each and giving notice to the Company of the assignment of the policies to them. The beneficiaries then immediately surrender the policies receiving £775,000 each.

In 2020/2021 Longstem is neither resident nor ordinarily resident in the United Kingdom. Subject to this, Captain Broad and his sons have been and are at all relevant times resident and ordinarily resident in the United Kingdom and domiciled in England.

THE ARRANGEMENT IS MADE

Inheritance Tax

A transfer of value?

11.1 When the premium is paid, the policy issued and the trusts activated (which all happens simultaneously) Captain Broad makes a disposition. That disposition will be a transfer of value if it results in a decrease in the value of his estate.[45]

11.2 In order to determine whether there has been such a decrease one must value the Donor's estate immediately before and after the disposition is made. Before the disposition the Donor's estate included the money which he was about to pay by way of premia. After the disposition he had an absolute interest in the Regular Withdrawal Rights specified in the trustees' Withdrawal Form. The value of those rights will reflect prevailing interest rates, Captain Broad's life expectancy, the investment risks associated with the policy and the proportion between the withdrawals and the total policy value. In the example, their value on the day that the Arrangement is made is £304,815 so that the transfer of value is £695,185 (£1m - £304,815). The transfer of value will be a potentially exempt transfer because it is made by an individual on or after the 18th March 1986 and is a gift to individuals[46] (unless the contrary intention appears, words in the singular include the plural).[47]

[45] Section 3(1)
[46] IHTA 1984 s.3A
[47] Interpretation Act 1978 s.6

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Capital Gains Tax

11.3 There will be no Capital Gains Tax chargeable on the Arrangement being made.

Income Tax

11.4 There will be no Income Tax payable on the Arrangement being made.

The Pre-Owned Assets Charge

11.5 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 paragraph 8 provides 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."

11.6 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.

11.7 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.”

11.8 The trusts of the policy are not a settlement for this purpose because the trust property is held absolutely for the Donor, as to the Settlor’s Fund and for the beneficiaries, as to the Residual Fund. It is therefore not property held in trust for persons in succession or for any persons subject to a contingency nor is it held on trust to accumulate the income or to make discretionary payments out of that income nor is it charged or burdened with a periodical payment.

11.9 The Pre-Owned Assets Charge can also apply to the occupation of land and to the possession and use of chattels, neither of which is relevant to the Arrangement.[48]

11.10 So the Pre-Owned Assets Charge will not apply to the Arrangement implemented by Captain Broad.

11.11 Had Captain Broad used the discretionary trust there would have been property subject to a settlement. What is the property which is subject to that settlement? The efficacy of the Arrangement depends on the property not including the rights to the Regular Withdrawal benefits. It is argued that these rights are separate items of property and therefore that there are two dispositions of property, a disposition of the rights held in the Settlor’s Fund which is not a settlement and a disposition of the rights held in the

[48] FA 2004 Sch 15 paras 3 and 6

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residual fund which is. This appears to have been accepted by HMRC for many years.[49] Is HMRC correct to do so?

11.12 It might be argued that it is highly artificial or, adopting in the negative form the word approved by Lord Nicholls in *BMBF*,[50] highly unrealistic, to regard the individual contractual rights arising under the contract with the Company as separate items of property. The trustees have entered into a single contract under which they have given global consideration for a bundle of rights. A breach of a condition of that contract such as a refusal by the Company to pay the Regular Withdrawal benefit, for example, would surely be sufficient to allow the policyholder to repudiate the entire contract. Arguably, the rights under the contract are so dependent upon one another that it is unrealistic to regard them as individual items of property rather than as parts of the same property.

11.13 That view gains support from the form of s.43 which provides a detailed definition of settlement and then defines 'settled property' as the property comprised in a settlement. The section does not direct its attention to the effects of the disposition concerned, referring to the disposition falling within the definition as a "settlement". Whichever version of the Arrangement Captain Broad had implemented he would have made a single payment to the insurance company of the amount of the premium and the insurance company would have issued a single policy to the trustees. The trusts of the policy would be governed by a single document, the trust deed. It is surely at least arguable that this is a single disposition of property consisting of the policy.

11.14 It is at least arguable, that there is a settlement within s.43 wherever there is a disposition of property and, as a result, some part of that property satisfies the conditions of ss.43(2)(a)–(c).

11.15 Of course, it has long been accepted by HMRC that rights to benefits under a policy are separate items of property so it may be unlikely that HMRC will change their view. If they were to do so, however, it is not clear that they would be wrong in so doing.

11.16 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."

11.17 We argue below[51] that if the policies used in the Arrangement are to be regarded as single items of property, then the policies in the Arrangement would be property subject to a reservation. That being so, the Pre-Owned Assets Charge would not apply. So the Pre-Owned Assets Charge will not apply to either the bare trust or discretionary trust versions of the Arrangement either because the Settlor's Fund is not property comprised in a settlement within FA 2004 Sch 15, para 8(1)(a) or because the rights arising under the policy are settled property and are property subject to a reservation.

---

[49] See Inheritance Tax Manual paras 20423 - 20427

[50] *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UK HL5I at para 36

[51] See paras 3.5.5 – 3.5.14 below

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11.18 In practice, it appears that HMRC will accept that the Regular Withdrawal Rights are not settled property and that the Pre-Owned Assets Charge does not apply.[52]

CAPTAIN BROAD SETTLES HIS RIGHT TO THE FIRST THREE WITHDRAWALS

Inheritance Tax

A Transfer of Value

12.1 Each settlement of the three individual Regular Withdrawal Rights is a disposition which reduces the value of Captain Broad's estate and which is therefore a transfer of value. Immediately before the disposition his estate will include the right to a payment one month later which is contingent on his surviving for one month. Immediately on the disposition his estate will no longer contain that right which will then be beneficially owned in equal shares by Longstem and Sercombe. These transfers of value will be potentially exempt transfers because they are made to an individual and the whole of the value transferred is attributable to property which, by virtue of the transfer, becomes comprised in the estate of those individuals.

Section 21 does not apply

12.2 Under general principles the proceeds of withdrawals from the policies will be capital[53] and therefore the proceeds cannot be included in the settlor's income in calculating whether the transfers are exempt as normal expenditure out of income under s.21.

A Measure of the Transfer of Value

12.3 The amount of the transfer of value may be very much less than the amount of the Regular Withdrawal Payment which is the subject of the disposition. That is because a purchaser will receive nothing if Captain Broad were to die before the Regular Withdrawal Right became payable.

12.4 Section 167 provides that:-

> "(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

[52] See the correspondence between HMRC and the Association of British Insurers of September 2004 which is quoted at para 4.4.24 below

[53] See *Sagden v Kent* [2001] SSCD 158

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(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,"

12.5 It does not appear that s.167 can apply in respect of Captain Broad's disposition because a capital redemption policy is not a policy of insurance, because we are not called upon to determine the value of the policy but rather of an individual withdrawal right arising under the policy and because the transfer does not "result in the policy or contract ceasing to be part of the transferor's estate."

Capital Gains Tax

The Collective Redemption Bond

12.6 A gain accruing on a disposal of, or of an interest in, the rights conferred by a capital redemption policy is not a chargeable gain[54] and a loss is not an allowable loss.[55]

The Collective Investment Bond

12.7 What would the situation be if Captain Broad had opted for a Collective Investment Bond?

12.8 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),

[54] TCGA 1992 s.204
[55] Section 16 ibid

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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."

12.9 If he had opted for a Collective Investment Bond Captain Broad would have disposed of an interest in the rights conferred by a policy of insurance. Those rights would not, at any time, have been acquired for consideration other than the consideration given by the trustees by way of premium and, therefore, their disposal could not have given rise to a chargeable gain or have resulted in an allowable loss.

Income Tax

12.10 As we have said, 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."[56] A gain on a policy may arise when a chargeable event occurs in relation to the policy or contract.[57]

12.11 A chargeable event may occur where a part of the rights under the policy or contract is assigned but only if the assignment is for money or moneys worth.[58] Captain Broad's assignment under deed of his Regular Withdrawal Right on the trusts of the Residual Fund is not made for consideration and therefore does not give rise to a chargeable event gain.

THE FIRST REGULAR WITHDRAWALS PAYMENTS ARE RECEIVED BY THE TRUSTEES ON THE TRUSTS OF THE RESIDUAL FUND

Inheritance Tax

13.1 The receipt of the Regular Withdrawal Payments does not have any Inheritance Tax consequences.

[56] ITTOIA 2005 s.461(1)
[57] Section 462(1) ibid
[58] ITTOIA 2005 s.498(1)

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Capital Gains Tax

13.2 The receipt of the Regular Withdrawal Payment is a receipt of a capital sum within TCGA 1992 s.22 and therefore there is a disposal of an interest in the policies by Longstem and Sercombe. A gain accruing on a disposal of, or of an interest in, the rights conferred by a capital redemption policy is not a chargeable gain[59] and a loss is not an allowable loss so no gain arose.[60] Had Captain Broad chosen a Collective Investment Bond no chargeable gain or allowable loss would have arisen on these disposals because the rights would not at any time have been acquired by any person for actual consideration.[61]

Income Tax

13.3 The falling due of a sum payable as a result of a right under a policy or contract to participate in profits where further rights remain under it is deemed to be a surrender of a part of the rights under the policy or contract.[62]

13.4 Where there is a surrender of a part of the rights under a policy a calculation is to be made under s.507 to determine whether there is a chargeable event gain.[63] Because the cumulative withdrawals under the policy are less than five per cent per annum of the premium paid in respect of a policy no chargeable event gain will arise.

CAPTAIN BROAD DIES

Inheritance Tax

The Charge on Death

14.1 On the death of any person tax is charged as if immediately before his death he had made a transfer of value, the value of which was equal to the value of his estate immediately before his death.[64]

Valuation

14.2 Under s.171:-

> "(1) In determining the value of a person's estate immediately before his death changes in the value of his estate which have occurred by reason of the death and fall within subsection (2) below shall be taken into account as if they had occurred before the death.

---

59 TCGA 1992 s.204
60 Section 16 ibid
61 TCGA 1992 s.210
62 ITTOIA 2005 s.500
63 Section 498 ibid
64 Section 4

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(2) A change falls within this subsection if it is an addition to the property comprised in the estate or an increase or decrease of the value of any property so comprised, other than a decrease resulting from such an alteration as is mentioned in section 98(1) above; but the termination on the death of any interest or the passing of any interest by survivorship does not fall within this subsection."

14.3 The general rule is that the value at any time of any property is the price which that property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the grounds that the whole property is to be placed on the market at one and the same time.[65]

14.4 Under the terms of the trust, Captain Broad's interest in the Settlor's Fund ceases on his death but in valuing that interest for the purposes of s.4 one takes no account of the cessation because of s.171(2). One must, therefore, value the rights to future withdrawals immediately before Captain Broad's death. Immediately before his death, Captain Broad had a right only to the specified Regular Withdrawal Payments falling due during his lifetime. The next withdrawal payment was not to become payable until eleven months later. As Captain Broad was at that time in such a state of health that he would die at the next instant having already been diagnosed two months before as having a terminal disease and a life expectancy of just three months it is clear that a person purchasing the rights in the market would pay little or nothing for them.

Gifts with Reservation

14.5 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

[65] Section 160

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(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."

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

14.7 On the face of it, one might think that it is the whole policy which is the subject of the gift. It is the policy which vests in the trustees. It is true that under the trust the regular withdrawal rights under the policies are held for the Settlor's Fund whereas all of the other rights under the policies are held for the beneficiaries absolutely but those rights arise under the single contract and it is arguable that it would be unrealistic to regard them as separate items of property rather than as rights arising under a single item of property.[66]

14.8 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 the retention of a current and vested interest in property (the lease) which was not subjected to the trusts to which the freehold was subjected.[67]

14.9 That is very different to the Arrangement which uses, not a lease which is an interest in land *in rem*, but rather contractual rights *in personam* arising under a single contract.

14.10 Even if one allows that the subject of the gift for the purposes of FA 1986 s.102 is the rights under the policy shorn of the Regular Withdrawal Rights it is far from clear that "possession and enjoyment of the property is … bona fide assumed by the donee at or before the beginning of the relevant period." It is true that the policy creates surrender

[66] See para 3.2.10 above
[67] A similar point could be made in relation to the lease considered in relation to New South Wales Stamp Duties in the Estate Duty case of *Munro v Commissioners of Stamp Duties of New South Wales* TC [1934] AC 61

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and maturity rights ab initio. The trustees, however, as we have seen, are prevented in equity from exercising those rights until the Donor has died.[68]

14.11 Nor is it clear that the property is enjoyed to the entire exclusion, or virtually to the entire exclusion, of the Donor and of any benefit to him by contract or otherwise. The surrender benefit and the maturity benefit are calculated partly by reference to the amounts paid under the Regular Withdrawal Rights to the Donor so the enjoyment of the rights held for the beneficiaries is intimately connected to the Regular Withdrawal Benefits paid to the Donor.

14.12 In the absence of specific case authority it is difficult to predict with any degree of probability how a Court would apply the reservation of benefit rules to the Arrangement.

14.13 So there are strong arguments to suggest the Policies might be property subject to a reservation. It appears, however, that it has long been accepted by HMRC that the Donor, in discounted gift schemes, has not reserved a benefit in the policy.[69]

14.14 FA 1986 Sch 20 para 7(1) provides that:-

> "(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),
>
> (c) 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."

14.15 This provision does not apply to Captain Broad's Arrangement because a capital redemption policy such as the Collective Redemption Bond is not a policy of life insurance. Even if Captain Broad had used a Collective Investment Bond para 7 would still not have applied because, under the Arrangement, where that bond is used it is written on lives other than those of the Donor or his spouse.

Capital Gains Tax

14.16 On Captain Broad's death, the Regular Surrender Rights to which he was absolutely entitled immediately before his death, were extinguished. Under TCGA 1992 s.24 that

[68] See para 3.1.13 above
[69] Inheritance Tax Manual paras 20423 - 20427

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would constitute a disposal of the rights were it not for s.62(1) which provides that the assets of which a deceased person was competent to dispose are not to be deemed to be disposed by him on his death whether or not they are the subject of a testamentary disposition.

Income Tax

14.17 Because Captain Broad's death is not an event leading to a benefit under the policies becoming payable it is not a chargeable event.

The Overall Effect of Captain Broad's Death

14.18 Providing that Captain Broad has not reserved a benefit in the polices as a whole, therefore, he has managed to pass assets to his children with a total value of £1,655,000 (£1,545,000 + £110,000) at his death without suffering any Inheritance Tax whatsoever.

THE POLICIES ARE SURRENDERED

Inheritance Tax

15.1 Immediately before the surrender Longstem and Sercombe had policies which they could surrender immediately and receive a surrender benefit equal to the policy value. On the surrender they have a right to a payment of the surrender benefit. There is, therefore, unlikely to be any significant transfer of value because the estates of Longstem and Sercombe will not have been reduced to any significant extent by reason of the surrender.[70]

Capital Gains Tax

15.2 A chargeable gain does not arise on the surrender.[71]

Income Tax

15.3 The complete surrender of the policies is a chargeable event.[72] The chargeable event gains arising on the disposals are calculated as follows.[73]

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[70] Section 3
[71] TCGA 1992 s.204. See para 3.4.2 above
[72] ITTOIA 2005 s.484(1)
[73] ITTOIA 2005 s.491. Strictly, the calculation should be made in relation to each policy but for simplicity a single global computation is made.

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	£	£
Value of policy	1,550,000	
Capital sums paid under the policy and contract before the event	237,180	
TB (Total Benefits)		1,787,180
TD (Total Allowable Deductions) Premium paid		1,000,000
PG (Gains on precious chargeable events)		0
Chargeable event gains		787,180

15.4 Sercombe is chargeable to Income Tax on his chargeable event gain of £393,590 (£787,180 ÷ 2).[74] Because the policies are foreign policies Sercombe is not treated as having already paid Income Tax at the basic rate on the chargeable event gain as he would have been had the policies been issued by a UK insurer.[75] Longstem, on the other hand, is not assessable on the chargeable event gain arising in respect of his policies because he is not UK resident at any time in the tax year in which the surrender takes place.

15.5 The order of events is very important here. Had the trustees surrendered the policies after appropriating them to the beneficiaries but whilst they were still the registered owners, it is arguable that the trustees would have been liable to Income Tax on the chargeable event gain arising in respect of the policies appropriated to Longstem.[76]

CONCLUSION

16.1 The Arrangement has allowed Captain Broad to continue to receive an annual sum from the policies whilst making a gift of the surrender and maturity benefits under the policies with the result that no charge to Inheritance Tax arises in respect of them. That result, however, is dependent upon HMRC continuing to regard such arrangements as not giving rise to a reservation of benefit. As we have seen, that view is, at the least, technically uncertain. It is based on a long-standing practice, however, and to reverse it would have a substantial effect on a significant part of the insurance and savings industry in the UK so it is probably reasonable to rely on the practice continuing to be applied at least to policies issued before any announcement of a change of view. It is disturbing, however, that the Inheritance Tax Manual lists discounted gift schemes as "avoidance devices".[77]

[74] ITTOIA 2005 s.465
[75] Sections 530 and 531 ibid
[76] Section 467(3) and (4) ibid
[77] See Inheritance Tax Manual para 9152

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