INHERITANCE TAX PLANNING - TRUSTS, INSURANCE AND ALTERNATIVES:

TRUSTS, INSURANCE POLICIES AND ALTERNATIVE STRUCTURES COMPARED

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INTRODUCTION

1.1 The insurance industry has developed a major market in supplying Inheritance Tax planning arrangements as a means of selling its investment products. Although these arrangements sometime use other types, the primary products employed are redemption policies and policies of life insurance.[1]

1.2 In this lecture we examine the nature of life insurance and capital redemption policies,[2] we examine the characteristics which make them particularly appropriate for Inheritance Tax planning and we compare those characteristics with those of other legal relationships used in Inheritance Tax planning. We examine the characteristics under three headings; risk protection, the separation of derivative rights and administrative convenience.

LIFE INSURANCE POLICIES

The Lack of Statutory Definition

2.1 The Inheritance Tax, Capital Gains Tax and Income Tax legislation contain no general definition of "insurance", "life insurance" or "policies of life insurance." Nor is a generally applicable definition of insurance or of a contract of insurance to be found in non-fiscal statutes. A definition is provided for the purposes of the regulations issued under the Financial Services and Markets Act 2000 which define a contract of insurance for the purposes of those regulations as:-

> "….. any contract of insurance which is a long term insurance or a contract of general insurance."[3]

2.2 It then goes on to list a number of items, none of which are relevant to the Mutual Payments Contract, as being included within this definition. The definition is therefore not exhaustive but serves both to extend and restrict, for the purpose of the orders, the definition of "insurance" which is to be sought elsewhere.

2.3 'Life insurance' is a subset of insurance, not a separate category. It is therefore necessary first to decide whether any particular contract is a contract of insurance and then whether it is a life insurance contract.

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[1] As a 'capital redemption policy' is a statutorily defined phrase in order not to beg the question of whether the products issued by the companies fall within this definition, we refer to policies designed to fall within the statutory definition of a capital redemption policy as 'Redemption Policies' except where we are specifically referring to policies falling within that statutory definition

[2] See note 1 above

[3] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544)

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THE NATURE OF AN INSURANCE POLICY

The Lack of an Exhaustive Definition in Case Law

3.1 The Courts, as a deliberate policy, have avoided providing a general definition of insurance. Templeman J remarked in *Department of Trade & Industry v St Christopher Motorist Association*[4] that:-

> "….. no difficulty has arisen in practice, and therefore there has been no all-embracing definition, and the probability is that it is undesirable that there should be, because definitions tend sometimes to obscure and occasionally to exclude that which ought to be included."

3.2 The American courts have been more willing to consider the nature of insurance. Clark in the Law of Insurance Contracts says:-

> "… when the Courts, both English and sometimes American, focus on the issue in hand, to fashion a concept of insurance, that is conditioned by the context and the result tends to take a two dimensional shape. The effect on insurance law is not one view of insurance but several according to context. Moreover, a characterisation fitting in certain contexts may be unsuitable in others. So, an important feature of the cases is the focus on purpose – purpose of the legislator or purpose of the particular contract."[5]

3.3 Clark says further:-

> "Although unwilling to define the insurance contract or to go much further than is necessary to decide whether the particular contract in issue is insurance or not, English Courts are willing to describe insurance contracts."

Descriptive Features (indicia) of Insurance Policies

3.4 From these cases supplemented by cases heard in the American and other foreign courts one can extrapolate features of contracts which indicate whether or not the contract is a contract of insurance. Although some features are of more importance than others none is necessarily determinative. What is more the matter must be judged in the context of the purpose of the contract concerned and the purpose of the legislation which would apply to the contract concerned if it were a contract of insurance.

3.5 The Financial Services Authority has published guidance[6] on the identification of contracts of insurance which, although it has no legal authority, provides a useful summary of the relevant legal principles and of the Authority's practice in applying those principles.

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[4] *Department of Trade & Industry v St Christopher Motorist Association* 1 All ER 395 at pp 395 & 396
[5] The Law of Insurance Contracts by Malcolm A Clarke, 4th Edition, Release 11 at page 4-2
[6] Perimeter Guidance Instrument 2005/31 – PERG 6 Guidance On the Identification Of Contracts Of Insurance

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3.6 The starting point for most discussions of the meaning of insurance is Mr Justice Channell's enumeration of the characteristics of an insurance policy in *Prudential Insurance v IRC*:-[7]

> "It must be a contract whereby for some consideration usually but not necessarily for periodical payments called premiums, you secure to yourself some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event. Then the next thing that is necessary is that the event should be one which involves some amount of uncertainty. There must be uncertainty whether the event will ever happen or not, or if the event is one which must happen at some time, there must be uncertainty as to the time at which it will happen. The remaining essential is that which was referred to by the Attorney-General when he said the insurance must be against something. A contract which would otherwise be a mere wager may become an insurance by reason of the assured having an interest in the subject matter – that is to say, the uncertain event which is necessary to make the contract amount to an insurance must be an event which is prima facie adverse to the interest of the assured. The insurance is to provide for the payment of a sum of money to meet a loss or detriment which will or may be suffered upon the happening of the event. By statute it is necessary that at the time of the making of the contract there should be an insurable interest in the assured. It is true that in the case of life insurance it is not necessary that the interest should continue, and the interest is not the measure of the amount recoverable as in the case of a fire or marine policy. Still, the necessity of there being an insurable interest at the time of the making of the contract shews that it is essential to the idea of a contract of insurance that the event upon which the money is to be paid shall prima facie be an adverse event. Thus a contract depending upon the dropping of a life, such as a contract whereby two or more people purchase a property as joint tenants with the object of the longest liver getting the benefit of survivorship, would not be a contract of life insurance, although it would be a contract with reference to a contingency depending upon a life or lives; it would not be a contract of insurance at all."[8]

3.7 If this were an exhaustive definition a contract for the provision of future services would be a contract of life insurance and it is recognised that it cannot do service on its own as an overriding definition. It does point to the essence of insurance, however, that it is concerned with protection against uncertainty.

Risk Transfer and Distribution

3.8 The American Courts have seen the shifting and spreading of risk as fundamental to insurance.

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[7] *Prudential Insurance Company v IRC* [1904] 2 KB 658

[8] The requirement of 'adversity' was criticised in succeeding cases

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3.9 In *Group Life and Health Ins. Co v Royal Drug Co.*[9] the United States' Supreme Court stated that two of the 'primary elements of an insurance contract' are the shifting (or underwriting) of risk, and the distribution (or spreading) of risk.

> "Risk shifting emphasises the individual aspect of insurance: the effecting of a contract between the insurer and the insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasises the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance".[10]

3.10 In Clark[11] it is said that:-

> "An essential feature of insurance is that risk is transferred from A, the insured, to B, the insurer. Accordingly, "self insurance" by A is not insurance."

3.11 The categorisation of a contract is to be made by reference to its substance rather than its description and form although, in borderline cases, the description and form of the contract can be of importance.[12] In determining the contract's substance one primarily looks at the purported insurer's obligations under the contract.[13]

Risk of Loss to the Purported Insurer

3.12 It has been said that insurance involves the insurer in accepting the risk of loss.[14] Although doubt has been cast on this in respect of life assurance the acceptance of risk by the insurer is at least an indication that the contract is one of insurance and its absence that it is not. Because insurance will normally or, perhaps always, involve the transfer of risk to the insurer it is characteristic of an insurance contract that the amount of the premium is not intended to be equivalent to the value of the insurer's actual performance (if any) but is calculated in relation to the likelihood that performance will be required (or will be required within a certain time). It is this characteristic which distinguishes, for example, a simple contract for maintenance services from a maintenance insurance contract.[15]

3.13 The Financial Services Authority's Guidance states:-

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9 *Group Life and Health Ins. Co v Royal Drug Co.* 440 US 205
10 *Commissioner of Internal Revenue v Treganowan* (1950)183 F 2d 284 at p.291
11 The Law of Insurance Contracts by Malcolm A Clarke, 4th Edition, Release 11 at para 1-7
12 *Re Barrett* (1992) 106 ALR at p563. See The Law of Insurance Contracts by Malcolm A Clark, 4th Edition, Release 11 at page 1-5 and the Financial Services Authority's PERG 6. Guidance on the Identification of Contracts of Insurance para 6.5.1(1)
13 PERG 6. Guidance on the Identification of Contracts of Insurance para 6.5.4(2)
14 *Pailin v Northern Employer's Mutual Indemnity Society* [1925] 2 KB 73 and *Wooding v Monmounthshire & South Wales Mutual Indemnity Society* [1939] 4 All ER 570
15 MacGillivray on Insurance Law 10th edition (publ Thompson Sweet & Maxwell) at para 1-2

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> "A contract is more likely to be regarded as a contract of insurance if the amount payable by the recipient under the contract is calculated by reference to either or both of the probability of occurrence or likely severity of the uncertain event".[16]

The Description and Form of the Contract

3.14 Although, as has been said, the question of whether a contract is a policy of insurance must be decided primarily on its substance, the nature of the parties and the form and description of the contract are also of significance when no clear answer is given by considering the contract's substance.

The Parties

3.15 An insurer under a contract of insurance will usually be in business as such. *Hall D'Ath v British Provident Association*[17] was decided on the basis that an indemnity agreement with a charity could not be an insurance contract because the charity did not carry on business as an insurer. The case concerned the interpretation of a statute regulating the insurance industry so one cannot assume that a contract of insurance must have as one of its parties a person carrying on business as an insurer but, if this condition is not satisfied, it is an indication that the contract is not one of insurance.

The Description of the Policy

3.16 An insurance policy will normally be described as such either in the contract itself or in the parties' dealing with one another leading to the formation of the contract. The lack of such a description is at least an indication that the policy is not a policy of insurance.[18]

Characteristics of the Contract as a Whole

3.17 Whether or not a contract is a contract of insurance is not to be decided by balancing individual elements of insurance and non-insurance within the contract but rather upon a characterisation of the contract as a whole.[19]

WHAT IS A POLICY OF LIFE INSURANCE?

Differences of Emphasis

4.1 As has been said, 'life insurance' is a subset of 'insurance' not a separate category. Because the question of whether a contract is a contract of insurance is not a matter of applying an overarching definition, however, but rather of considering the particular contract in the light of the indicia of insurance, it may be that, in considering particular

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[16] PERG 6. Guidance on the Identification of Contracts of Insurance para 6.6.8 (1)

[17] *Hall D'Ath v British Provident Association* (1932) 48 TCR 240

[18] *Fuji Finance Inc v Aetna Life Ins Co Ltd and Another* [1996] 4 All ER 608 see PERG 6 Guidance on the Identification of Contracts of Insurance para 6.6.8.(3)

[19] *Fuji Finance Inc v Aetna Life Ins Co Ltd and Another* [1996] 4 All ER 608 at page 618

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categories of insurance, different weightings are to be given to the indicia than might be given in considering other categories.

4.2 When looked at as a whole, the life insurance cases place greater emphasis on the triggering event being subject to uncertainty as to timing, an uncertainty that relates to the continuance or discontinuance of life, and place less emphasis on the insured obtaining protection against the risk of loss.

Assumption of Risk by the Insurer

4.3 So, for example, in *Flood v Irish Provident Assurance Company Limited*[20] the fact that the purported insurer did not assume any risk of loss did not prevent the policy concerned from being a policy of life assurance. This was in the context, however, of the issue of what was described as an endowment policy which provided benefits on survival for a term or an earlier death in consideration of the payment of weekly premia by policyholders who are characterised in the case as the 'thrifty poor.' The context gave a flavour of insurance to the contract which could not be displaced by the lack of one of the normal indicia of insurance.

Provision for the Future

4.4 In the *Prudential* case, Mr Justice Channell had said that:-

> "It is essential to the idea of a contract of insurance that the event upon which the money is to be paid shall, prima facie, be an adverse event."[21]

4.5 In relation to a life insurance policy, he considered that the possibility that the insured event should have adverse consequences for the insured need not continue after the insurance is made and the benefit payable need not be measured by the loss from the adverse event:-

> "….in the case of life insurance it is not necessary that the interest should continue, and the interest is not the measure of the amount recoverable….Still the necessity of there being an insurable interest at the time of the making of the contract shows that it is essential to the idea of a contract of insurance that the event upon which the money is to be paid shall prima facie be an adverse event."

4.6 In *Gould v Curtis*[22] two of the three members of the Court of Appeal rejected this requirement that the event on which the insurer is to pay benefits under the policy must be adverse to the interests of the insured and in *Medical Defence Union Ltd v Department of Trade and Industry*[23] Sir Robert Megarry VC considered that Mr Justice Channell's requirement of adversity had not been confirmed by subsequent authority:-

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[20] *Flood v Irish Provident Assurance Company Limited* [1912] 2 Ch 597
[21] *Prudential Insurance Company v Inland Revenue Commissioners* [1904] 2 KB 658
[22] *Gould v Curtis* [1913] 3 KB 84 at pages 91 & 94
[23] *Medical Defence Union Ltd v Department of Trade and Industry* [1979] 1 Lloyd's Rep 499-505

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"Adversity, *though commonly present,* [emphasis added] is not an essential of insurance."

4.7 In *Gould v Curtis*,[24] however Lord Justice Kennedy had seen the essence of life insurance, as providing against the expenses of longevity:-

> "In a sense, and particularly with regard to the insurances affected by workmen for small weekly payments, it may well be said that such an insurance against what may happen to the man or to his family in regard to the possibility of wage earning at a later period of his life is insurance for an adverse event, namely, the coming of a time when, although he is still living, it may be more difficult or even impossible for him to earn wages as before. In the same way you may use the word 'adverse' in speaking of death. It is equally true that, speaking generally (and we are not legislating in the clouds, but for actual human events that happen in the community), death is an adverse event as regards the family and creditors, and that is why a creditor has an insurable interest in the life of the debtor. You desire to guard….against the happening through old age or death of an event which, unless you provide against it by thrift, will result, I will not say in adversity or anything adverse, but in a position of pecuniary disadvantage against which the thrifty person desires, and rightly desires, to insure himself, or his family or his creditors.
>
> Therefore there is, in that sense, in reference to a contingency relating to the duration of human life, the happening of an event – of course it is not like the burning of a house or the destruction of a ship, and has no reference to the question of indemnity – but an event which places a man from a pecuniary point of view in a less favourable position than he otherwise would have occupied. Therefore, while I agree that the word 'adverse' may not be quite the right word to use as a universal test, still I think it was properly used in reference to the policies which Channell J. was considering."

4.8 Although, therefore, it is not an essential of insurance that the insured event must be adverse to the interests of the insured, the concept of adversity remains relevant to insurance. A contract may be one of life insurance even where there is no financial loss which will arise from the trigger event relating to the duration of a human life. Nonetheless provision against the financial vicissitudes of the future is at least an indicium of insurance. In an Australian case, *National Mutual Life Association of Australasia Ltd v FCT*[25] Mr Justice Windeyer said that forms of insurance policies that were not life insurance policies:-

> "……..indemnify the insured against loss from events which may or may not occur. Life insurance on the other hand is related to a contingency, death, which must occur. It is not a risk, it is a certainty; the only uncertainty is when it will occur. This does not mean that the aim of the life policy holder is always provision against the inevitable rather than a caution against the possible. He may

[24] *Gould v Curtis* [1913] 3 KB 84 at pp 97 & 98

[25] *National Mutual Life Association of Australasia Ltd v FCT* [1959] 102 CLR 29 at para 10

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wish to insure the life of a creditor for a term, or he may be concerned by the risk of death depriving dependants of support or of the loss of income in old age; so that it has been said that a whole life policy is an insurance against dying too soon, an endowment policy an insurance against living too long."

The Event Insured must be Dependant upon a Life

4.9 The Courts have seen the defining characteristics of a life insurance policy as being that the event insured is dependant upon a life. Thus in *Gould v Curtis*, Lord Justice Buckley said:-

> "An insurance upon life is the creation in favour of the person who has an insurable interest of an obligation to pay money in an event, namely, the contingency of human life. Whether the contingency be the continuance of life at a date or whether it be death, in both cases it seems to me that it is included within the expression "insurance on life" contained [in the legislation relevant to the case]."[26]

4.10 It should be noted, however, that this emphasis on the dependence of the insured event on the continuance, or discontinuance, of a human life is found in distinguishing life insurance policies from other types of insurance policies. It does not exclude entirely the notion of adversity or risk distribution. The connecting concept is that of provision for the future.

4.11 If life assurance were solely defined as being a contract under which a benefit is payable by reference to the death of a person, personal accident policies would also be policies of life insurance. In *National Mutual Life Association of Australasia Ltd*[27] Mr Justice Windeyer differentiated between the two on the basis that:-

> "….life policies are completely susceptible of actuarial calculation for the purposes of valuation or the determination of premium rates, the data needed being the same for all forms of life policy, namely an assumed rate of interest and appropriate mortality tables; whereas in other forms of insurance determination of probabilities would seem to have a less scientific basis although we were informed that tables of accident experience exist................
>
> Insurances against accident or death do in some ways resemble life policies ………….. Yet ordinary accident policies providing for payment on accidental death have been held not to be life policies for the purposes of provisions in bankruptcy and similar legislation by which life policies are protected….
>
> It has been suggested that the distinction between personal accident and life policies based upon the inevitability of death and the uncertainty of accident is unsound; since nearly all life policies except some deaths, for example by suicide or in an aeroplane; so that the contingency in respect of which they operate, it was

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[26] *Gould v Curtis* [1913] 3KB 84 at page 94
[27] *National Mutual Life Association of Australasia Ltd v FCT* [1959] 102 CLR 29 at paras 12-15

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suggested, is not inevitable. This is true, but the accepted risks are, in general, matters which the insured can voluntarily avoid, whereas the very purpose of an accident policy is to insure against injuries or illnesses which are not avoidable. Existence of excluded risks in life policies does not, in my view, at all impair the validity of the distinction between them and accident policies.

Accident and sickness policies also differ from most life insurances in that they are ordinarily only annual contracts. At most they are like fire and burglary and other miscellaneous policies. Even when an accident or sickness policy is renewable at the option of the insured, it differs markedly from a life policy in that it has no surrender value, each annual premium being in effect the consideration for the cover for the ensuing year".

4.12 It is clear therefore that although the primary characteristic which distinguishes life policies from many other types of insurance policies is that the event triggering the payment of benefits is the continuance, or discontinuance, of a life the presence of this characteristic is not in itself sufficient to make any particular contract a policy of insurance nor is it sufficient to exclude a policy from falling into some other category of insurance. If that were not the case then Mr Justice Channell's "….contract depending upon the dropping of a life, such as a contract whereby two or more people purchase a property as joint tenants with the object of the longest liver getting the benefit of survivorship…."[28] would be a contract of insurance. That is because it would be a contract whereby a benefit in money or money's worth (the survivor taking an undivided, absolute interest in land by virtue of survivorship) would accrue to a person contingently upon a human life.

4.13 An important characteristic of insurance is the element of provision for the future. That is a characteristic which is found in many modern forms of insurance policies which, in effect, offer an investment return by calculating the policy benefits by reference to the value of a segregated group of the insurer's investments the initial value of which is determined by reference to a premium or premia paid by the policy holder. It was such a policy which was considered in *Fuji Finance Inc v Aetna Insurance Company Limited and Another*.[29]

Fuji Finance Inc v Aetna Insurance Company Limited and Another

The Facts

The Contract

4.14 The plaintiff company, *Fuji*, entered into a contract with a company carrying on an insurance business which was later transferred to the defendant company, Aetna. The

[28] See para 10.4.6 above

[29] *Fuji Finance Inc v Aetna Life Insurance Company Limited and Another* [1996] 4 All ER 608

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contract was described by the issuer as both a "life assurance policy" and as a "capital investment bond". Under the policy *Fuji* paid a premium of £50,000.

The Policy Benefits

4.15 The policy required the insured to maintain certain funds as sub divisions of its long term business funds. Policy benefits were payable under the policy on the death of T (the prime mover of *Fuji's* operation and the person described in the policy as the life assured) (the "Death Benefit") or the earlier surrender of the policy during T's life (the "Surrender Benefit"). These benefits were calculated by reference to the value of various funds in which the premium was "invested". This investment and the subsequent allocation of units in these funds was only notional and for the purpose of determining the policy benefits. The assets of the fund remained the property of the issuing company. If the policy were surrendered in the first five years, the surrender payment would be subject to a small discontinuance charge. The benefit payable on death was calculated as 100% of the amount which was payable on surrender except that there was no discontinuance charge in the first five years of the policy's life.

Fund Switches

4.16 The policy holder had the option to switch the funds to the value of which the benefits under the policy were linked.

Form of the Policy

4.17 The policy was thus in a conventional form for insurance policies marketed as investments except that the death benefit would in most circumstances be the same as the surrender benefit which would have been paid had the policy been surrendered on the day of death.

The Pricing Anomaly

4.18 The value used in calculating notional disinvestments and reinvestments on switches between funds was fixed on the day of surrender by reference to the value of shares on the previous day. T realised that he would be able to work out whether a switch would result in a gain or not and *Fuji* made continuous switches on his advice. In 1991 the value of the policy had grown to over £1.1m.

The Repudiation of the Contract

4.19 The insurance company then changed its method of calculating the switch values. *Fuji* regarded this as a repudiation of its contract and they accepted the repudiation by surrendering the policy. *Fuji* then sued for damages on the basis that they would have received a 90% annual return for the whole of T's life which resulted in a claim for damages which, Aetna calculated, would result in a sum equivalent to the gross national product of the United Kingdom for 460,000 years.

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The Issues

The Relevant Issue – was the policy a policy of life assurance?

4.20 *Fuji* accepted that if the policy were a policy of life assurance it was void to the extent that it exceeded its insurable interest in T's life and that they had already received surrender moneys in excess of the value of that interest.

4.21 They argued that the policy was not a policy of life insurance and therefore it was not void. Aetna argued that it was.

The Second Issue

4.22 In the alternative, Aetna argued that if it were not a policy of life insurance it was void by virtue of the Insurance Act 1982 s.16(1) which provided:-

> "An insurance company to which this part of this act applies shall not carry on any activities in the United Kingdom or elsewhere, otherwise than in connection with or for the purposes of its insurance business."

4.23 There was therefore a preliminary hearing on these two issues. It is the decision of the Court on the first issue (the "Relevant Issue") which is relevant to the Mutual Payments Contract.

The High Court

4.24 The High Court in finding for *Fuji* had concluded that the policy was not a contract of insurance. Vice Chancellor Sir Donald Nicholls had stated that:-

> "In my view, to be within *section 1 [LAA 1774]* a sum of money (or other benefit) must be payable on an event uncertain, either as to its timing or as to its happening at all, and that event must be dependant on the contingencies of human life."

4.25 He had found that no sum of money was payable on an event which was uncertain and dependant on the contingencies of human life because the amount payable on the policy coming to an end at any time was, with one small exception, the same whether the occasion was the surrender of the policy or the death of the life assured.

The Court of Appeal

Key characteristics of the Fuji Contract

4.26 In the Court of Appeal emphasis was given to a number of characteristics of the contract. First, the contract gave two separate rights and benefits to *Fuji*;[30] the Surrender Benefit and the Death Benefit.

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[30] *Fuji v Aetna Life Insurance Co and Another* [1996] 4 All ER 608 at PP 611 and 612, 617, 618, 626 and 627

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4.27 Secondly, the insurance company could suffer no loss on the contract. It was called upon only to pay an amount the excess of which over the premium paid would be matched by the growth in the value of the investments to which it was linked. That was perhaps surprising in view of the fact that *Fuji*, through the anomaly in Aetna's pricing method which T had identified, was, in effect, making a one way bet with Aetna on the movement in the values of the underlying investments. The explanation is perhaps that the loss matching Fuji's profit fell upon the funds and was, in effect, borne by the other policy holders because their benefits were calculated by reference to the reduced value of the funds.[31]

4.28 Thirdly, the policy was described by the issuing insurance company as an insurance policy and it took the form of a normal insurance contract having provision, for example, for the deduction of a mortality cost from the benefit payable under the policy although that cost was not in fact deducted.[32] The whole policy had the appearance of an insurance policy.

4.29 The leading judgment was delivered by Lord Justice Morritt and in relation to the Relevant Issue represents the ratio decidendi on that issue. Sir Ralph Gibson simply agreed with Lord Justice Morritt's judgment. Lord Justice Hobhouse delivered a separate, consenting judgment briefly rehearsing the same arguments as those advanced by Lord Justice Morritt on the Relevant Issue.

Essential Principles

4.30 Lord Justice Morritt derived five important principles from case law.

4.31 First that "the investment element of a policy, which has become such a feature of modern insurance, is consistent with its characterisation as a life policy."[33]

4.32 Secondly, that a policy may be one of life insurance even where there was no element of risk of loss to the insurer.[34]

4.33 Thirdly that "the essence of life assurance, as emphasised in all the cases, is that the right to the benefits is related to life or death."[35]

4.34 Fourthly, that whether or not a contract is a policy of life insurance is to be approached by considering the characterisation of the policy as a whole and posing the question whether so read it was a policy of life insurance.[36]

4.35 Fifthly, the fact that the policy is "clothed in the whole vesture of life assurance is at least relevant, though by no means conclusive, to the characterisation of the policy."[37]

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[31] *Fuji v Aetna Life Insurance Co and Another* [1994] 4 All ER 1025 at p.1028
[32] *Fuji v Aetna Life Insurance Co and another* [1996] 4 All ER 608 at p.612
[33] At 615 ibid
[34] At 616 ibid
[35] At 617 ibid
[36] At 618 ibid
[37] At 618 ibid

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A Narrow Issue

4.36 Subject to these principles, Lord Justice Morritt stated that the issue to be resolved in the case was a narrow one:-

> "Is the fact that subject to certain exceptions, the measure of the benefit payable on surrender is the same as that payable on death sufficient to prevent this contract being recognised as "insurance…..made on the life…..of any person?"[38]

4.37 He thus posed the question in a negative form. He assumed that the policy was a policy of life insurance unless the fact that "the measure of the benefit payable on surrender is the same as that payable on death" was sufficient to negative that assumption.

4.38 He concluded that it was not. He analysed the contract as one under which there were two benefits provided to the policy holder; the Death and Surrender Benefits, and concluded that both were related to life or death. Obviously, the Death Benefit was related to the life assured's death but Lord Justice Morritt concluded that the life benefit was also:-

> "In this case, as Counsel for *Fuji* accepted, the policy came to an end on the death of Mr Tait so that, subject to notification in the prescribed manner, the benefits then crystallised. Thus the right to surrender was related to the continuance of life, for it could not be exercised by *Fuji* after the death of Mr Tait. I do not suggest that a policy which contained condition (7) [the Surrender Benefit] without also including condition (5) [the Death Benefit] would be a policy of life assurance. But I see no reason why a policy which contains both should be denied that character."[39]

4.39 Having thus determined that both events are life or death related Lord Justice Morritt went on to say:-

> "If the event on which a benefit is payable is sufficiently life or death related, then I can see no reason in principle why it should matter if that benefit is the same as that payable on another life or death related event."[40]

4.40 He then concluded that the policy must be a policy of life assurance presumably by applying the approach which he commended of "considering the characteristics of the policy as a whole and posing the question whether so read it was a policy of life insurance."[41]

4.41 In doing so, however, he admitted the possibility that it may be necessary that the Surrender benefits and the Death benefits differ, and concluded that they did in any case:-

[38] At 617 ibid
[39] At page 617 ibid. See also the remarks of Lord Justice Hobhouse at page 626
[40] At page 617 ibid
[41] At page 618 ibid

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"But even if it is necessary that the benefits should differ between one event and another, I do not see any reason why the difference must arise from the description of, or formula for fixing, those benefits. There is no doubt, given the fluctuations in the market, that over the term of the life of Mr Tait the value of the benefits receivable will change from valuation day to valuation day. Except in the case of unusual stability in the market, it is almost inevitable that the value of the benefits payable on death will be different from the value payable on surrender, and the value payable on surrender will vary according to when the surrender occurs."[42]

The Vesture of Life Assurance

4.42 Finally, he went on to say that his conclusion was confirmed by the fact that there was a difference between the benefits payable in the first five years of the policy on surrender and on death and by the whole form and description of the policy:-

"….as Nicholls V-C observed, the whole policy is 'clothed in the vesture of life insurance', which is at least relevant, though by no means conclusive, to the characterisation of the policy."[43]

WHAT IS A CAPITAL REDEMPTION POLICY?

ITTOIA 2005 Section 473(2)

5.1 A capital redemption policy is any contract effected in the course of a capital redemption business.[44] Capital redemption business is "any business of a company carrying on insurance business in so far as it consists of the effecting on the basis of actuarial calculations, and the carrying out, of contracts of insurance under which, in return for one or more fixed payments, a sum or series of sums of a specified amount become payable at a future time or over a period …".[45]

"a contract"

5.2 It is clear that Redemption Policies are contracts between the original policyholder (and later assignees of whom notice is given to the insurance company) and the insurance company.

"effected in the course of a capital redemption business"

5.3 They are effected in the course of the insurance company's business. Is that business a capital redemption business?

[42] At page 618 ibid
[43] At page 618 ibid
[44] ITTOIA 2005 s.473(2)
[45] ICTA 1988 s.431(2ZF)

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"… contracts of insurance …"

5.4 Does it consist of the effecting of contracts of insurance? Halsbury's Laws summarises the essential features of insurance contracts as being:-

> "that a sum of money will be paid by the insurers on the happening of a specified event; there must be uncertainty as to the happening of the event, either as to whether it will happen or not, or, if it is bound to happen, like the death of a human being, as to the time at which it will happen. There must also be an insurable interest in the insured, which is normally that the event is one which is prima facie adverse to his interest."[46]

5.5 It is clear that this general definition would not be satisfied by the wide range of contracts marketed as capital redemption contracts under which a sum of money is to be paid on a fixed date in the future in return for one or more earlier payments. It is clear, however, that the statutory definition in ICTA 1988 s.458 (3) envisages that a contract of just this sort can be a contract of insurance and therefore the word "insurance" in s.450 (3) is not to be confined to the narrower definition given in Halsbury's Laws. As we have seen, however, some form of provision against risk or uncertainty is the essence of an insurance contract. That element is to be found in Redemption Policies in the fact that such policies normally provide that the sum payable on maturity cannot be less than a guaranteed maturity value which will often be set as twice the premia paid under the policy.

"a sum or series of sums of a specified amount"

5.6 Is a "specified amount" payable under such policies? Normally the amount payable will vary by reference to the performance of the funds in which the policy premia are notionally invested. So it might be argued that this condition is not satisfied. To adopt such a restricted construction, however, would be to exclude from the definition many commonly accepted by HMRC as capital redemption policies. The better view is surely that the amount is specified in the sense of being calculated in a pre-determined manner.

"becomes payable at a future time or over a period"

5.7 Under most Redemption Policies, an amount becomes payable at a fixed time in the future, the Maturity Date, in return for one or more payments but the policies also normally provide for sums to be paid on partial or complete surrender. Does it matter that amounts may be paid at dates other than the maturity date? It might be argued that if such a policy is surrendered early no amount will become payable on the Maturity Date and therefore an amount does not become payable at a fixed time or over a period. To take such a restrictive view of the legislation, however, would be to undermine the accepted taxation treatment of many policies commonly accepted by HMRC as capital redemption policies. Comfort may be taken from the case of *Fuji Finance Inc*[47] where, as

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[46] Halsbury's Laws of England, Insurance 1. Introduction (1) Origin of Common Principles, (2) Principles Common to all Insurances

[47] *Fuji Finance Inc v Aetna Life Assurance Co Ltd* CA [1997] Ch 173

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we have seen, the question considered was whether the fact that under a policy benefits were payable both on death and on early surrender and were calculated in a similar way prevented that policy from being a policy of life insurance. As we have seen, the Court, declining to apply a restrictive view, found that it had not. Even though it was possible that no benefit would ever become payable by reference to a death the fact that it might become so payable was sufficient to make the policy a policy of life insurance.

"On the basis of actuarial calculations"

5.8 Although actuarial work is traditionally associated with life assurance and pensions, actuarial techniques are applied to general insurance, derivatives, investments, healthcare provision and capital project financing. Actuarial techniques involve analysis of past events and the use of the results from such analyses to model, using mathematical techniques, the long term financial implications of business decisions. The application of economic theory and compound interest calculations to investment decisions is therefore a core element of actuarial work which is reflected in the subjects forming an actuary's training.

5.9 It is clearly necessary for an actuarial calculation to be made in respect of most Redemption Policies because it is necessary for the insurance company to consider whether the likely return over the policy term on the investments in which the premia are notionally invested will result in the encashment value exceeding the guaranteed maturity value.

Case Law

5.10 The case of *Sugden and Kent*[48] concerned a policy issued by an offshore insurer under which for the payment of a single premium, the insurer undertook to make a payment on a maturity date ninety nine years after the issue of the policy. The payment was to be calculated by reference to the value of the units in which the premium had been notionally invested. The taxpayer had a right to payments of approximately £20,000 per annum achieved by notionally surrendering some of the units to which the maturity benefit was linked. After the death of the taxpayer the holder of the policy could surrender the policy in whole or in part for a value which was again determined by reference to the value from time to time of the units in which the fund was notionally invested.

5.11 The taxpayer contended that his annual receipts of £20,000 were capital receipts taxable under ICTA 1988 ss.539-534.[49] The case report does not say which provision applied, within this range of sections, under the taxpayer's contentions. The Inland Revenue contended that the payments were revenue in nature and represented an annuity.

5.12 The Special Commissioner concluded:-

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[48] *Sugden v Kent* SpC [2001] SSCD 158

[49] The chargeable event gain legislation now found in ITTOIA 2005 Chapter 3 Part 9

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"….that the annual payments were intended to be in the nature of a return of capital; there was an agreed purchase price, namely £200,000, which determined the extent of the obligation of the insurance company; and the bargain was always thought of in capital terms.

Accordingly, my decision on the issue for determination in the appeal is that the annual payments were capital in nature and so taxable under ss 539-554 of the 1988 Act with the result that £10,000 of each payment is tax free and the other £10,000 is a gain chargeable to income tax. The whole of the annual payments is not taxable as income under Case V of Sch D as annuity payments with a foreign source"

5.13 Plainly the question of whether the payments, if capital in nature, were taxable under ICTA 1988 Part XIII and whether they were so taxable because they were Capital Redemption Policies within s.539(1), did not form part of the ratio decidendi of the case. The Special Commissioners' judgment proceeded on the assumption that, if they were capital in nature, they would be taxable under ICTA 1988 Part XIII. In respect of the question of whether policies commonly marketed as redemption policies are indeed Capital Redemption Policies some comfort may be drawn, however, from the fact that the contract considered in the case was clearly neither a policy of life assurance nor a purchased life annuity and so it is to be inferred that Part XIII could only have applied to the policy concerned if it were a capital redemption policy.

The Revenue's views

5.14 The Revenue manuals describe a capital redemption policy in the following manner:-

"Capital redemption policies, though issued by insurance companies, are not strictly speaking insurance products.[50] They were once known as investment bond contracts, which is more descriptive but needs to be distinguished from the type of life policy investment bond described at IPTM1100. Under capital redemption policies, one or more fixed sums is paid to an insurer under a contract pursuant to which one or more specified amounts is paid out at some later time or times, on the basis of an actuarial calculation. Typically the contracts take the form of:-

- an annuity certain, where a capital sum is used to buy an annuity for a fixed term not contingent on life, see IPTM4200, or
- a sinking fund where regular sums are paid in to secure a capital sum at some later date, for example against the need to find a premium payment to renew a lease.

The statutory definition of capital redemption business is at ICTA 1988 s.458(3). Contracts within such business are long term insurance business but not life

[50] This is plainly wrong. As we have seen, they must be "effected in the course of a capital redemption business" and such a business consists of "the effecting … and the carrying out, of contracts of insurance" (see para 5.1 above)

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business. A capital redemption policy that creates a debtor/creditor relationship, with an agreement to return the sum advanced, is known as a capital redemption bond and is similar in nature to a relevant or deeply discounted security, see IM1520. However, such bonds, which may only be sold by an insurer, are removed from the scope of the deeply discounted securities income tax charge of ITTOIA s.427 onwards."[51]

PROTECTION AGAINST RISK

6.1 We have seen that protection against risk is the essence of life insurance and to a lesser extent of capital redemption policies. The management of mortality risk is a key part of Inheritance Tax planning for Inheritance tax is easily avoided. All one has to do is to give away one's property seven years or more before ones death and one's problems disappear. So if we knew our date of death and we could be certain of what is going to happen to us during the last seven years of our life, Inheritance Tax planning would be easy but, of course, we cannot. So, taking cover against the risk of early death and the vicissitudes of life is vital to Inheritance Tax planning.

6.2 Life insurance policies allow the issuing company to pool the risk of early death amongst its customers. Capital redemption policies cannot do this. To some extent, trusts, companies and partnerships provide some degree of risk pooling in as much as they allow the pooling of assets held for groups of members or beneficiaries. Such 'pools' are inevitably much shallower than can be provided by substantial insurance companies. Risk cover, therefore, is one of the key advantages of insurance policies for Inheritance Tax planning.

THE SEPARATION OF DERIVATIVE PROPERTY RIGHTS

7.1 Insurance policies enable one to create multiple sets of derivative property in investment assets differentiated by time. So, benefits payable in life may be separated from benefits payable on death. The one thing which everybody in Inheritance Tax planning wants to do is to be able to give away property but continue to enjoy the use of it and to enjoy the security which it offers. In the past, in avoiding death or estate duties, achieving that goal was pursued mainly through the use of trusts but Capital Transfer Tax created a comprehensive regime to nullify their use. Inheritance Tax reinforced that regime by reviving the Estate Duty reservation of benefit rules and it was underpinned by the Income Tax charge on pre-owned assets. Then in 2006 the relevant property regime was extended to most trusts other than bare trusts.

7.2 So although it possible to use trusts to create derivative interests in property divided over time, Inheritance Tax largely operates by disregarding that division and treating a settlement of property as a transfer of value of the whole property.

7.3 In contrast, there are no equivalent provisions to tax the rights arising under the life insurance or capital redemption policies as an aggregate asset. So, for example, a settlor who creates a trust of property under which he retains a life interest will be treated as

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[51] Revenue Manuals IPTM1120

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making a chargeable transfer of the entire settled property. If he pays a premium to an insurance policy retaining withdrawal rights but making a gift of the maturity benefits, HMRC accept both that the rights are separate items of property and that a benefit is not reserved in the withdrawal rights which he retains.[52] The technical position in relation to a reservation of benefit is unclear but HMRC's practice is long standing.

7.4 In a sense, both companies and partnerships also create derivative interests in underlying assets. Companies can indeed be used to create property limited by time. Rights over income and capital conferred by shares can change at particular times or on the happening of particular events. Inheritance Tax, however, attempts to ensure that the passing of value from one estate to another resulting from such changes is measured at the time of the change rather than at the time of the issue of shares. It does this through IHTA 1984 s.98 which provides that:-

> "(1) Where there is at any time -
>
> (a) an alteration in so much of a close company's share or loan capital as does not consist of quoted shares or quoted securities[2]
>
> (b) an alteration in any rights attaching to unquoted shares in or unquoted debentures of a close company,[2]
>
> the alteration shall be treated as having been made by a disposition made at that time by the participators, whether or not it would fall to be so treated apart from this section, and shall not be taken to have affected the value immediately before that time of the unquoted shares or unquoted debentures.[2]
>
> (2) In this section "alteration" includes extinguishment.
>
> (3) The disposition referred to in subsection (1) above shall be taken to be one which is not a potentially exempt transfer."

7.5 Partnerships also can create rights divided over time. They have not been much used in Inheritance Tax planning for this purpose but it may be that with the current intense interest in family limited partnerships and in limited liability partnerships that will change.

Administrative Convenience

7.6 Insurance policies are administratively convenient, particularly for small and medium sized estates. They do not give rise to income so they do not require complex trust account or trust returns. They do not require complex investment decision making, because that is done by the insurance company within the policy. Insurance companies have become adept to supplying standard legal documentation wrapped up as part of the package and in exploiting the tax advantages that their products can offer by creating

[52] It is not difficult to circumvent the provisions of FA 1986 Sch 20 para 7

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products specifically designed to confer those advantages. Often the companies will act as trustee of the trust created over the insurance policy.

7.7 Trusts, companies and partnerships, by contrast, are not bespoke arrangements and often require large amounts of expensive professional advice in their establishment. Companies require annual accounts complying with the Companies Acts. Standard sets of Articles allow for a standardised approach to management but often require considerable amendment to suit individual situations. Corporate income need not be distributed to the shareholders but tax returns are still required for the company. If the shares are to be subjected to trusts, the trust documentation must be individually drafted and persons found who are willing to take on the role of trustees.

7.8 Similarly, for limited liability partnerships, trust accounts and trust taxation returns will be necessary. Although accounts are not required by statute for ordinary partnerships, in practice one cannot dispense with them if one is to comply with the partnership's tax reporting obligations. Where investment assets are held it will normally be necessary for the partners to obtain investment advice and, if only some of the partners are involved in the management of the partnership, it will normally be necessary to sub-contract investment decision making to an authorised investment adviser.

CONCLUSIONS

8.1 So, insurance policies are well suited in many ways to meeting the needs of the Inheritance Tax planning market and can offer characteristics which are not available, or not fully available, for alternative structures. It is not surprising that capital tax planning through insurance policies burgeoned in the 1970's after the introduction of Capital Transfer Tax in 1974. After a period of great success, however, the insurance tax planning industry went rather sour. Many, if not most, policies used in capital tax planning are in effect investment policies with tax advantages added. The opacity of insurance policies presented a temptation to insurance companies and salesmen alike to hide excessive charges and poor investment performance under a tax planning cover. The result is that many professionals advising private clients today have a deep rooted suspicion of the use of insurance policies in tax planning.

8.2 If insurance based Inheritance Tax planning arrangements are stripped of their marketing packaging and their inner workings revealed, however, they often prove to be worthwhile and useful additions to the tax planner's armoury.

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