Inheritance Tax

Insurance Valuations

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Insurance policies are an invaluable tool in inheritance tax (IHT) planning. For that very reason, a certain amount of anti-avoidance legislation has grown up to restrict their advantages including the valuation provisions of Inheritance Tax Act 1984 (IHTA 1984) s.167. This article considers IHTA 1984 s.167 and explores some of its quirks.

In most common forms of life insurance policies, a person entering into a policy pays a premium or premia in return for the right to be paid benefits on maturity and, often, on surrender. The maturity of the policy will be dependent to some extent upon the continuance or cessation of a life or lives assured. By way of illustration of the valuation principles examined in this article, we shall look at a conventional single premium investment bond and a single, whole of life, regular premium policy providing a level sum assured.

Two common forms of policy

Single premium investment bonds

Investment bonds mimic the economic features of collective investments whilst, because they are policies of life insurance, receiving the tax treatment which applies to such policies.

A typical investment bond will be written on one or more lives including the life of the person to whom the policy is issued. It will provide for the payment of a surrender value on the surrender of the policy (in whole or in part) at any time and a maturity value on the death of the life, or of the last of the lives, assured.

The surrender value, at any time, will be determined by the value of a group of assets of the insurance company accounted for in units into which the premium is notionally invested. It would be normal for the bond to provide for an initial premium to be paid and, at the option of the policy holder, for further premia to be paid. Often, the insurance company will apply the premium received first to a charge and make a notional investment of only the net amount in units. Further annual charges are then met by encashing small numbers of units. It is important to understand that the whole mechanism of "units", "charges" and "encashments" is simply a way of calculating the benefits payable under the policy. It is merely a hypothetical or fantasy world. The assets notionally divided into units remain at all times the property of the insurance company and the contract between the insurance company and the policy holder is simply a contract for the payment of benefits calculated in accordance with the unit mechanism in return for the policyholder's payment of premia.

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Single, whole of life, regular premium policy

Under a single, whole of life, regular premium policy for a level sum assured, the policyholder pays premia at regular intervals of a year or less of a level amount in return for the company's undertaking to pay a fixed sum on the death of the life assured. Such policies are commonly used to create funds outside a taxpayer's estate (either held in trust or gifted) which will not themselves bear IHT on the taxpayer's death and will be available to his heirs to meet the IHT arising on his death.

The relevant statutory provisions

The general method of valuation—IHTA 1984 s.160

The general method of valuing property for the purposes of IHT is provided by IHTA 1984 s.160, which reads:

> "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."

A supplementary rule for certain life insurance and annuity policies—IHTA 1984 s.167

In respect of certain life insurance and annuity policies, the general rule in IHTA 1984 s.160 is supplemented by the specific provisions of IHTA 1984 s.167, which provides:

> "(1) In determining in connection with a transfer of value the value of a policy of insurance on a person's life or of a contract for an annuity payable on a person's death, that value shall be taken to be not less than-
>
> (a) the total of the premiums or other consideration which, at any time before the transfer of value, has been paid under the policy or contract or any policy or contract for which it was directly or indirectly substituted, less
>
> (b) any sum which, at any time before the transfer of value, has been paid under, or in consideration for the surrender of any right conferred by, the policy or contract or a policy or contract for which it was directly or indirectly substituted.
>
> (2) Subsection (1) above shall not apply in the case of -
>
> (a) the transfer of value which a person makes on his death, or
>
> (b) any other transfer of value which does not result in the policy or contract ceasing to be part of the transferor's estate …
>
> …
>
> (5) References in subsections (1) … above to a transfer of value shall be construed as including references to an event on which there is a charge to tax under Chapter III of Part III of this Act (apart from section 79), other than an event on which tax is chargeable in respect of the policy or contract by reason only that its value (apart from this section) is reduced."[1]

[1] IHTA 1984 s.167(3) (which excludes from these provisions certain term policies) s.167(4) (concerning certain regular premium unitised policies) are omitted.

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It can be seen from IHTA 1984 s.167(2) that the special valuation rules will only apply to a transfer of value otherwise than on death which results in the policy or contract ceasing to be part of the transferor's estate. Where the special rules apply, they ensure that the amount of the transfer of value will not be less than the premia which have been paid under the policy less certain payments in respect of the surrender of rights under the policy.

Investment bonds

Entering into the policy

When a person enters into a policy, he will make a disposition. That disposition will be a transfer of value for IHT purposes if it results in the value of his estate immediately after the disposition being less than it would be but for the disposition.[2] If the disposition is a transfer of value, it will be a chargeable transfer unless it is an exempt transfer.[3] The disposition will certainly not be a potentially exempt transfer because the value transferred will not be attributable to property which by virtue of the transfer becomes comprised in the estate of another individual nor will it increase the estate of another individual.[4] If, therefore, the policy on inception has a value which is less than the diminution in the policyholder's estate by reason of the consideration to be given by the policyholder under the policy, there will be a chargeable transfer.[5]

In what circumstances will all these conditions be satisfied? One might argue that many insurance policies are worth less immediately after they are issued than the initial premium paid for them. For example, as we have seen, it is common in investment bonds for initial charges to be made before the notional allocation of units and for the units to have a bid/offer spread under which the price at which they are allocated in satisfaction of the premium will be higher than the price at which they are redeemed in satisfaction of policy benefits. The result is that if one takes out an investment bond and surrenders it immediately afterwards, the surrender value of the bond is likely to be less than the amount of the premium paid under the policy. Accordingly, one might argue that the market value of the policy will similarly be less than the amount for which it was acquired.

That, however, is surely an incorrect view of the matter. There is a large and competitive market in investment bonds. A large number of customers of the insurance companies take out such bonds on the basis that the company's charges (including the initial charges built into the structure of the policy) are worth bearing in order to have the advantages conferred by the policy. Those are the benefits of the policy structure, the financial strength of the insurance company, the administration of the policy and the management of the investments to which the policy benefits are linked. So the mere fact that the surrender value of the policy immediately after it comes into effect is less than the premium paid in respect of it does not mean that its market value will necessarily be less than the premium paid.

Of course there will be situations in which the original policyholder has made a bad bargain. For example, insurance companies offer commission to financial advisers on their products. Those advisers will often forego that commission by agreement with their clients so that a larger amount of the premium is allocated to units but, often, only when their clients request them to do so. A naïve client who does not do so, will have made a chargeable transfer.[6] Such chargeable transfers are not likely to be very large but if, for example, a policyholder allows his financial adviser to take 2 per cent more commission than is the market norm on an investment policy with an initial premium of £2 million, he might, subject to IHTA 1984 s.10, make a transfer of value of £40,000 (£2 million at 2 per cent).

[2] IHTA 1984 s.3(1).
[3] IHTA 1984 s.2(1).
[4] IHTA 1984 s.3A(2)(b).
[5] Subject to IHTA 1984 s.10 which is discussed below.
[6] Unless IHTA 1984 s.10 (see below) has the effect that the making of the policy is not a transfer of value.

Possibly more significant are situations where, for tax planning purposes, terms are added to otherwise standard policies which are of advantage to the issuing company with no corresponding adjustment to the premia payable on the policy. For example, after the trust "reforms"[7] of 2006, it has been necessary to find new ways of making gifts to benefit young adults without giving absolute control of substantial assets to them. A solution offered by one insurance company is to create a policy (a "No Surrender Value Policy") which cannot be surrendered during the life of the life assured. The policy is simply the company's standard investment bond shorn of its surrender rights. The company does not offer enhanced terms to reflect the fact that the funds are not available for immediate withdrawal. One might argue, therefore, that it is clear that those who take out such policies are paying more than the general market price for them.

If that is the case, does IHTA 1984 s.10 protect against an IHT charge? Section 10 provides:

> "(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either -
>
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
>
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.
>
> …
>
> (3) In this section -
>
> 'disposition' includes anything treated as a disposition by virtue of section 3(3) above;
>
> 'transaction' includes a series of transactions and any associated operations."

Where an insurance policy is taken out in order to be the subject of a gift, as is commonly the case in IHT planning, it is clear that the provisions of IHTA 1984 s.10 cannot be satisfied. That is because IHTA 1984 s.10(1) does not look only at the disposition in isolation but also at the transaction or series of transactions of which it is a part. Where a policy is taken out with the intention of it being subject to a subsequent gift which is in fact made, it is clear that it is part of a series of transactions and that that series of transactions was intended to confer a gratuitous benefit on a person. So IHTA 1984 s.10 will not prevent either the client who makes a bad bargain in taking out an insurance policy or who takes out a No Surrender Value Policy from making a transfer of value if that policy is taken out with the intention that it will be the subject of a subsequent gift.

There is a further argument in relation to the No Surrender Value Policy which might protect from an IHT charge. One presumes that the company sells a reasonable number of such policies to a variety of persons who are willing to accept worse terms than those which apply to most policyholders[8] because of the tax advantages which the arrangement offers. Even so, one might expect individuals taking out such policies to negotiate with the insurance company to force an improvement in the other terms of the policy. Applying the classical economic assumption of a perfect market, one would expect the insurance company to be willing to offer such enhanced terms. If it is not, it is surely because the group of potential policyholders to whom the product is relevant is too small for it to be worthwhile for the insurance company to offer special terms. In effect, there is a market of those who wish to use No Surrender Value Policies for IHT planning which is separate from the general market for investment bonds. So it may be, after all, that the premia paid by those who take out No Surrender Value Policies are indeed set at market prices.

[7] In referring to the last Government's claim to have "reformed" the inheritance taxation of trusts in 2006, we enter an altogether darker world of fantasy than the virtual world of unitised insurance policies.

[8] In the sense that the surrender rights are excluded with no corresponding reduction in the premium or increase in other benefits.

Be that as it may, where an individual takes out a policy, in circumstances where there *is* an immediate chargeable transfer and he subsequently makes a gift of that policy, there will be an element of double counting because of the application of IHTA 1984 s.167 to the subsequent gift. The following example illustrates the point.

Example

Mr Keeve takes out an investment bond on his own life paying a premium of £1 million. The market value of the bond and its surrender value immediately upon issue is £950,000. A few days later, he makes a gift of the bond on bare trusts for his children when the market and surrender values are unchanged. A year later he dies unexpectedly early. A death benefit of £950,000 is paid under the policy.

On taking out of the bond, he makes a chargeable transfer of £50,000 (£1 million - £950,000). On making a gift of the bond, he makes a potentially exempt transfer which proves to be chargeable by virtue of his death. Because that is a lifetime transfer which has resulted in the policy ceasing to be part of Mr Keeve's estate, IHTA 1984 s.167 applies in determining the value of the policy. The effect of IHTA 1984 s.167(1) is that the policy is not to be valued at less than the previous premium paid of £1 million. Section 167(4) does not apply—it is a narrow provision which deals with the situation where there is an upward movement in the value of the units between the payment of premia and the allocation of units. So Mr Keeve had made aggregate chargeable transfers of £1,050,000, in spite of the fact that the policy has not, at any time, been worth, or had, a surrender value above, £950,000. The problem would be avoided if immediately upon issue the policy were held beneficially for the intended donee. If the policy is governed by UK law, that would only be possible if on issue the policyholder has an insurable interest in the life of the life assured under the policy.[9] Under the laws of many other jurisdictions, however, a policy is not void for lack of an insurable interest so there is much greater freedom for the policy to be held beneficially on issue by a person other than the life assured.

Regular premium, whole of life policies

IHTA 1984 s.167 can also have a peculiar effect in respect of regular premium, whole of life policies. In such policies the insurance company will always set the premia at a level where, in the early years, the premium charged in each year will be greater than that which would be charged (in a perfect market) for a single year's cover and this will reverse in later years. If one looks at each individual year, the premium one pays in an early year could be regarded economically as being paid partly for life cover in that year and partly for life cover in future years. In the early years, the policy will have some market value but its market value will be less than the total of the premia previously paid under the policy. So on a transfer of the policy, IHTA 1984 s.167 is likely to impose a higher value on that transfer than the market value of the policy transferred. Section 167(3) provides an exception to the valuation rule of the section for certain policies but that subsection applies only to term policies.

The following example illustrates the point.

Example

Mr Chapeau-Brun is 40 years old and takes out a whole of life policy on his own life for a level sum assured of £1,000,000. The annual premium is £8,200. When he is 50 years old he gives the policy to his son who will of course have to continue to pay the premia to maintain the policy. If the father were to take out a similar whole of life policy at the time of the gift the annual premium would be £13,000. The

[9] Life Assurance Act 1774 s.1.

policy has a market value at this time of £60,000 reflecting the fact that a person buying it would receive £1,000,000 on Mr Chapeau-Brun's death and would only have to pay £8,200 per year until that time in order to do so.

The total premia paid under the policy to date have amounted to £82,000 (£8,200 x 10). Accordingly, the amount of Mr Chapeau-Brun's potentially exempt transfer is £82,000, notwithstanding that the asset he has transferred has a market value of just £60,000. As before, IHTA 1984 s.167(4) does not apply as this is not a unitised policy.

Concluding observation

It is clear that even in relation to quite straightforward life insurance policies, IHTA 1984 s.167 can have really quite surprising results. The valuation of insurance policies for IHT purposes is less straightforward than it first appears.