No surrender!

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THE PROBLEM

FINANCE ACT 2006 SECTION 156 AND SCHEDULE 20

The changes to the Inheritance Taxation of Trusts made by the *Finance Act (FA) 2006* s.156 and Schedule 20[1] have the result that it is not possible to make a trust designed to benefit an individual by way of a lifetime transfer which does not fall within the relevant property regime of the *Inheritance Tax Act (IHTA) 1984* Part 3 Chapter 3 unless the trust falls within a very limited class of privileged settlements. Parents and grandparents who wish to pass their wealth on trust to the succeeding generations during their own lifetimes so as to minimise their Inheritance Tax liability on death must now either make an immediately chargeable transfer or an absolute gift on bare trusts. Under such an absolute gift the donee will receive unfettered control of the donated assets at the age of 18.

PROTECTING PRODIGAL SONS FROM THEMSELVES

At the time the changes were introduced, virtually the only people in the country who thought that they were a good idea were Government Ministers who, one presumes, have never had read to them the parable of the Prodigal Son. It is very rarely in the long-term interests of an 18-year old to be given unfettered control of substantial amounts of money. So advisers have turned their attention to finding ways in which gifts on bare trusts could be made of assets which it would be impossible, or at least, difficult, for a beneficiary to turn to account in the period during which he is insufficiently mature to be trusted to do so prudently.

THE COMPANY'S SOLUTION

It was a problem tailor-made for the insurance industry and commentators quickly suggested that a whole of life maximum investment policy on the life of the donor, with restricted surrender rights, would go a long way towards providing a solution. A well-known non-resident insurance company (the *'Company'*) has created an arrangement (the *'Plan'*) to meet the demand for such policies, which is being marketed as the successor to accumulation and maintenance trusts. This article describes the Plan and considers its taxation effects and whether it meets the need which it is designed to serve.

THE PLAN

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

THE GENERAL CONDITIONS

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

The Term and the Premia

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

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

The Notional 'Portfolio'

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

This group of assets is segregated in the accounts of the Company purely for the purposes of calculating the benefits paid under the policy. The assets comprised in the portfolio belong beneficially to the Company and not to the policyholder.

The management of the assets is undertaken by the Company but the policyholder may set a broad investment strategy to be followed by the manager and he may change this

1 All references in this article are to the *Inheritance Tax Act 1984* unless otherwise stated

broad strategy from time to time. It is a specific term of the policy that the policyholder has no right either to manage the underlying assets or to exercise any control over them whatsoever, although this must be subject to the policyholder's right to set the broad investment strategy.

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

Policy Benefits

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

Charges

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

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

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

Unrestricted Right of Assignment

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

THE SUPPLEMENTARY FORM

Surrender and Withdrawal Rights

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

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

THE DRAFT TRUST DEED

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

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

THE DRAFT ASSIGNMENT

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

'…the Assignor as beneficial owner hereby assigns unto the Assignee all that the Policy/ies and all monies which are assured thereby and all benefits and other monies which may become payable in respect thereof to be held by the Assignee as beneficial owner free from any trust or encumbrance.'

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

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

continues on p36

AN EXAMPLE

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

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

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

TAXATION ANALYSIS

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

THE CONTRACT IS MADE

A transfer of value?

When he takes out the policy, the policyholder makes a disposition. That disposition will be a transfer of value if it results in a decrease in the value of the estate of the person making it.[2] In our Example, Harry makes a transfer of value because, before entering into the policy his estate contains cash of £1,500,000 and after entering into it his estate no longer contains that cash but rather has a bundle of rights under the policy, which has a market value of £1,030,000. He therefore makes a transfer of value of £470,000. In fact, one would expect that in virtually every case there will be a transfer of value. The policy involves giving up a right to access the funds invested in it wholly or partly for a period. No enhanced return is offered for tying up one's money in this way as it would, for example, if one made a fixed-term deposit with a bank. That being the case, the value of the policy when it is made is almost certain to be less than the initial premium paid in respect of it. Whether that reduction in value will be significant will depend on the amount of the premia, whether withdrawal rights as well as surrender rights are suspended and the lengths of the suspension periods.

Is it an exempt transfer?

The transfer of value will not be a potentially exempt transfer because, although it is made by an individual, it is not a gift to an individual or to a privileged trust.[3] Indeed, it is arguable that it is not a gift at all. It will be a chargeable transfer unless it is exempt under any provision.[4] The Opinion suggests that it will not be a chargeable transfer because it will be exempt under *IHTA 1984* s.10. Sub-section 1 of that section provides that:

'(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either –

a. that it was made in a transaction at arm's length between persons not connected with each other, or

b. that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.'

For this purpose a *'transaction'* includes a series of transactions and any associated operations.[5] It seems clear that the making of the contract, the declaration of trust over the contract and the assignment of the contract to the trustees are a series of transactions (and they are also, of course, associated operations) and, therefore, that the transaction to be considered for the purpose of applying s.10(1) is a composite transaction, which includes the settlement of the policy and its assignment to the trustees.

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

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

On that basis, the possibility that the making of the contract will be an immediately chargeable transfer is a weakness of the Plan and it will be necessary, for any person implementing it, to pay careful attention to the

2 Section 3(1)

3 Section 3A(1A)

4 Section 2

5 Sub-section (3) *ibid*

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

THE ASSIGNMENT ON BARE TRUST

Inheritance Tax

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

a. made by an individual on or after the 22 March 2006;
b. would otherwise be a chargeable transfer; and
c. constitutes a gift to an individual.[6]

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

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'[7]

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

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

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

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

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

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

6 Section 3A(1A)

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

Income Tax

A policy taken out under the Plan will be a non-qualifying policy of life assurance for the purposes of the *Income Tax (Trading and Other Income) Act 2005 (ITTOIA)* Part 4 Chapter 9 and it will be a foreign policy for those purposes.[8] If there is a chargeable event in respect of the policy on which a chargeable event gain arises and the beneficiary is UK resident, that gain will form part of the beneficiary's assessable income, subject to both basic and higher rate Income Tax as appropriate.[9] The assignment of rights under a life assurance policy, however, is not a chargeable event for these purposes, so the assignment by the original policyholder to the trustees will not give rise to a chargeable event gain.

THE MATURITY OF THE POLICY

Inheritance Tax

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

Income Tax

The maturity of a non-qualifying policy of life assurance by reason of a death which gives rise to the payment of benefits under the policy will be a chargeable event. In calculating the chargeable event gain, however, the value of the policy taken into the calculation is not the amount payable on the maturity of the policy on the death, but rather the value for which it could have been surrendered immediately before the death.[10] So if the death occurs during the period in which the surrender right is suspended, and there is no withdrawal right, the value of the policy for the purposes of calculating the chargeable event gain will be nil and therefore there will be no chargeable event gain.

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

If the policy were to mature after the suspension period expired, however, when the policy had acquired surrender rights, the accumulated yield on the policy would be subject to Income Tax because, in effect, it would create a chargeable event gain. If, in our example, Harry Masters had provided for the surrender rights to be suspended only until Dabinett's 24th birthday on the 30 June 2023, there would have been a chargeable event gain on Harry's death of £1,940,000 (£2,940,000 - £1,000,000) forming part of Dabinett's assessable income for 2023/2024. Harry's survival for a little less than eight months after the suspension of the surrender rights would have proved to be very costly indeed. Assuming that Dabinett pays a marginal rate of Income Tax of forty per cent it would have cost £776,000 (£1,940,000 @ 40%).

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

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

The net result of Harry Masters' transaction in our example, for example, is that he has removed £2,945,000 from his estate (including investment growth of £1,945,000) and only £470,000 of that amount has borne Inheritance Tax. Because of the application of the nil-rate band and the annual exemptions and because the lifetime rates of Inheritance Tax apply, the total Inheritance Tax suffered is just £30,400 (20 per cent (£470,000 – (£312,000 + £3,000 + £3,000)) and, ignoring withholding tax suffered by the Company, there has been no Income Tax or Capital Gains Tax on the investment yield at all.

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

First, if an outright assignment is made, the donee will control the broad investment strategy of the investments linked to the policy by virtue of the policyholder's right to set that strategy. If the property is assigned to trustees, the trustees will hold that right but it will be subject to a duty to transfer the policy to the beneficiary at his request as from the age of 18.

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

It is not always easy to predict how one's children (or grandchildren) will develop in the future. Some people are financially prudent when very young,

8 *ITTOIA 2005* s.476(3)

9 *ITTOIA 2005* s.465(2), s.491, s.461 and s.463

10 *ITTOIA 2005* s.493(7)

others never become so. One of the difficulties of the Plan is that it requires the original policyholder to determine the period for which the surrender rights and withdrawal rights are to be suspended before the policy is issued.

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

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

A MARK II PLAN?

A Right of Veto over Surrender

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

Reservation of Benefit?

The obvious technical worry is that the right to veto a surrender might be a reservation of benefit within *FA 1986* s.102(1), on the basis that possession and enjoyment of the property will not have been bona fide assumed by the donee or, alternatively, or additionally, because the donated property is not enjoyed to the entire exclusion of the donor. In the present author's view there would be little risk of there being a reservation of benefit in the property because the retained rights would have been carved out before the gift.[11]

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

The pre-owned assets charge could not apply to the arrangement because the donor's gift would not be a gift of land and chattels and, if the right of veto were settled, it would be settled on trusts from which the donor was excluded.[12]

AN ACTIVATION RIGHT

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

An alternative approach might be to provide that there would be no right to surrender the policy at any time until the original life assured had exercised an option to activate that right. Once the ownership of the policy and this activation right had been separated it is difficult to see how there could be a surrender value for the purposes of *ITTOIA 2005* s.493 at any time before the right is exercised. The activation right could be settled in the same way as the right of veto.

CONCLUSION

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

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11 See *Munro* v *Commissioners of Stamp Duties of New South Wales PC* [1934] AC 61

12 *FA 2004* Sch 15 paras 3, 6 and 8