Prodigal Sons –

THE PROBLEM AND THE PLAN

You want to transfer some wealth to your offspring, but you don't want them to squander it before they reach maturity. *Simon McKie* describes one of the ways to do it

Since the inheritance taxation of trusts was changed by *Finance Act* 2006, s. 151 and Sch 20, advisers have sought ways of making gifts of assets that it would be difficult for a beneficiary to turn to account in the period during which he is insufficiently mature to be trusted to do so prudently.

This article examines an insurance arrangement (the Plan) created by a well-known non-resident insurance company (the Company) to meet this objective.

We consider the taxation effects of the Plan and whether it meets the need that it is designed to serve.

The Plan

The policies issued under the Plan are conventional single premium insurance bond policies. The policy documentation includes a draft bare trust and a draft deed of assignment. The Plan has been the subject of Counsel's opinion (the Opinion).

The term and the premiums

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 notional 'portfolio'

The benefits under the policy are calculated by reference to the value of a group of assets described as a 'portfolio'. Under the policy, the policyholder has no right either to manage the underlying assets or to exercise any control over them, although he can set a broad investment strategy.

Policy benefits

When the policy is surrendered in whole, an amount (the Surrender Benefit) becomes payable to the policyholder that is equal to the portfolio's value. 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 that is equal to the portfolio value at the time of death plus an additional amount.

Surrender and withdrawal rights

Under the company's general conditions, which apply to its single premium life products, the policy may be surrendered in whole or in part by the policyholder by written notice at any time. Regular withdrawals may also be made. On applying for a policy under the Plan, however, the applicant may specify an initial period during which there will be no option to surrender the policy. He may also specify an initial period during which the regular withdrawal right is either suspended or is restricted to a cumulative annual percentage of not more than 5%.
See the example on next page.

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.[1] 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.

AN EXAMPLE

Harry Masters is a wealthy man who has made no previous chargeable transfers. He wishes to make a transfer of his wealth. He takes out a policy under the Plan paying a single premium of £1,500,000 and completes the standard Draft Trust Deed so that the policy is held on bare trusts for his son, Dabinett. He immediately assigns the policy to the trustees. Dabinett will be 10 years old on 30 June 2009. Harry thinks that one is not usually mature enough to have unfettered control of substantial wealth until one is 30, so on taking out the policy he opts for the surrender right to be suspended until 30 June 2029, and he excludes all regular withdrawals until that date. The policy's market value subject to these restrictions at the time the policy was assigned was £1,030,000.

Harry dies on 21 February 2024 when Dabinett is a little over 25 years old and the portfolio value is £2,940,000. The policy matures on Harry's death and a maturity benefit of £2,945,000 is paid to the trustees. They receive it as bare trustee for Dabinett and, at his request, pay it to him.

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

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.[2] It will be a chargeable transfer unless it is exempt under any provision.[3] The Opinion suggests that it will be exempt under *IHTA* 1984, s. 10, which 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[4], so 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). The transaction to be considered for the purpose of applying s. 10(1), therefore, 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'.

The assignment on bare trust

Inheritance tax

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

(a) made by an individual on or after 22 March 2006;
(b) would otherwise be a chargeable transfer; and
(c) constitutes a gift to an individual.[5]

In determining the value transferred, s. 167 has the result that the measure of the potentially exempt transfer arising on the assignment is the higher of the loss to the donor and the premiums paid under the policy. In our example, that would be £1,500,000, the premium paid. That results in a potential for double taxation. If Harry Masters were to die immediately after subjecting the policy to bare trusts in favour of Dabinett, he would have made a chargeable transfer of £470,000 and, shortly afterwards, a potentially exempt transfer of £1,500,000, which, being within seven years of his death, would have proved to be chargeable. Inheritance tax would have been charged on £1,970,000 (£1,500,000 + £470,000), whereas in reality his estate would only have been reduced by £1,500,000. That is obviously an anomalous result and, on the basis of it, Counsel argues in the Opinion that HMRC are unlikely to take the point that there is a chargeable transfer of value at the time that the contract is made because, on a purposive construction, s. 10 is to be taken to apply to it.

The basis of this view is that the purpose of s. 167 is to prevent avoidance of tax through the payment of premiums in respect of policies subsequently given away that are worth less than the premiums. Counsel points out that in the case of the Plan, the potentially exempt transfer arising on the assignment is not less than the premium paid, so that no tax is avoided.

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

So not only would it appear that making the policy creates an immediately chargeable transfer, but there also appears a real risk that s. 167 could have the effect that the Plan would create a double charge to inheritance tax.

In practice, where the 5% 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 thinking of using it would need to consider the question of valuation extremely carefully before doing so.

Income tax

A policy taken out under the Plan will be a non-qualifying foreign policy of life assurance for the purposes of *ITTOIA* 2005, Part 4 Chapter 9.[6] 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.[7] The assignment of rights under a life assurance policy, however, is not a chargeable event for these purposes.

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, his potentially exempt transfer would prove to be a chargeable transfer.

Income tax

The maturity of a non-qualifying policy of life assurance by reason of a death that gives rise to the payment of benefits under the policy is 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.[8] So if the death occurs during the period in which the surrender right is suspended, and there is no withdrawal right, the policy's value for the purposes of calculating the chargeable event gain will be nil, and therefore there will be no chargeable event gain.

If the policy were to mature after the suspension period expires, however, when the policy had acquired surrender rights, the accumulated yield on the policy would be subject to income tax. If, in our example, Harry Masters had provided for the surrender rights to be suspended only until Dabinett's 24th birthday on 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.[9]

Is the Plan the solution to the problems that *FA* 2006 created?

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's 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 £27,800 (20% (£470,000 – (£325,000 + £3,000 + £3,000)) and, ignoring withholding tax suffered by the Company, there has been no income tax or capital gains tax on the investment yield at all.

Does the Plan succeed in allowing a donor to make a gift in a form that prevents the donee squandering the wealth he is given? The answer is that it will do so only partially. First, if an outright assignment is made, as soon as the donee is 18 he will control the broad investment strategy of the investments linked to the policy by virtue of the policyholder's right to set that strategy.

More significant 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, 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.

There is also a more fundamental point. 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 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.

Conclusion

The Plan gives considerable scope for allowing gifts to be made while protecting the donees from the effects of their own improvidence, but 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, is a significant drawback to which those considering using the Plan need to give careful attention.

Simon McKie is a designated member of McKie & Co (Advisory Services) LLP (01373 830956). This article is based on a longer piece, which appeared in the January 2009 issue of Trust Quarterly Review

1. *IHTA* 1984, s. 3(1). All statutory references unless otherwise stated are to the *Inheritance Tax Act* 1984.
2. s. 3A(1A)
3. s. 2
4. sub-section (3) ibid
5. s. 3A(1A)
6. *ITTOIA* 2005, s. 476(3)
7. *ITTOIA* 2005, s. 465(2), s. 491, s. 461 and s. 463
8. *ITTOIA* 2005, s. 493(7)
9. Assuming that Dabinett pays a marginal rate of income tax of 40%, it would have cost £776,000 (£1,940,000 @ 40%).