

Part surrenders and part assignments of life insurance policies consultation
Response from the Low Incomes Tax Reform Group,
and endorsed by Tax Help for Older People

1 Executive Summary

- 1.1 Please note that this response is from the Low Incomes Tax Reform Group (LITRG) of the Chartered Institute of Taxation (CIOT), but contributions to its content have been received from the separate tax charity, Tax Help for Older People,¹ and it is fully endorsed by them.
- 1.2 Key drivers in this reform should be both simplicity and fairness. Whichever solution is chosen, insurers will need to inform policyholders of the new tax rules, both generally (perhaps via annual valuation statements) and at the point a withdrawal or assignment is made.
- 1.3 We think that option 2 outlined in the consultation may be best – the 100% allowance – as this achieves both simplicity and fairness (in terms of taxing only economic gains). However, it could have adverse tax consequences in some scenarios once the allowance is exhausted as it brings into charge residual gains on surrenders in later years, or on final full encashment, of the policy.
- 1.4 Option 1 – taxing economic gains by means of an A/A+B formula – would be acceptable from a fairness perspective, though it would be more complicated for policyholders to comprehend, particularly the unrepresented. If this option were taken forward, it would be preferable if the insurance companies provide policyholders with calculations of taxable

¹ A service run by Tax Volunteers – see <http://www.taxvol.org.uk/about-us/>

gains (that is, not just the valuation figures required to calculate the gains) and clear instructions for reporting it to HM Revenue & Customs (HMRC). One slight downside to this option would be the potential still for gains to have been taxed in the past when there is an overall loss, depending on fluctuations in value over the term and at the time of surrender.

- 1.5 If it is decided to proceed with option 1, it will be necessary to confirm which policy value is to be used as 'B' in the formula. There could be a significant difference between the current policy value and the surrender value, particularly with the with-profits type policies to which a 'Market Value Adjustment' might be applied on surrender, for example.
- 1.6 Option 3 – deferral of excessive gains – should be ruled out altogether due to its complexity and continued possibility of taxing 'gains', in contradistinction to the economic reality of the underlying policy performance.
- 1.7 Whilst the consultation focuses on calculation of the amount of gain to be brought into charge, we believe there is also an opportunity for concurrent consideration of simplification and fairness of the underlying tax rules more generally. For example, it is unclear whether there is an intention to review, reform or abolish top slicing and corresponding deficiency reliefs; or to consider the interaction of taxation of income gains with the starting rate for savings and savings nil rate. There is an opportunity here to consider how the rules may be made clearer and fairer for all, particularly low-income taxpayers. See paragraphs 4.4 to 4.8.

2 About Us

- 2.1 The LITRG is an initiative of the CIOT to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.
- 2.2 LITRG works extensively with HMRC and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
- 2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 General comments

- 3.1 From section 2 above, it will be noted that we are approaching this consultation from the viewpoint of low-income, unrepresented taxpayers. By this we mean those who may not be

able to afford professional advice in relation to their tax affairs. This could encompass some holders of investment bond products, for example those who might have been advised to make this type of investment as part of retirement savings.

3.2 We also take into account that some people might not have what might be termed a 'low income' when taken at face value, but where means might nonetheless be stretched due to personal circumstances – such as those requiring personal care (disabled or elderly and frail people, for example). Their outgoings for basic living costs might be high relative to their income or capital means, thus making it difficult for them to afford to pay for advice on tax matters.

3.3 Where the questions are outside of our interest or expertise, we have answered with 'no comment'.

4 Question 1 – Of the suggested options for change, what is your preferred option? Please explain why?

4.1 For simplicity of understanding, we prefer the second option – the 100% allowance.

4.2 We believe that a significant principle of this reform should be to tax only the economic gain arising on the policy, which would therefore make the first option (calculating the economic gain by $A/A+B$ formula) the only other acceptable proposal in the consultation document. And even then, option 1 does give some risk of taxing gains on part surrender when on full and final surrender there is a loss, depending on fluctuations in value over the term and the timing of withdrawals.

4.3 The third option of deferring excessive gains would still mean fictitious 'gains' could be taxed, and the calculations appear frighteningly complicated even for qualified advisers – for the unrepresented, these rules would be unacceptable and would directly counteract efforts such as those made by the Office of Tax Simplification (OTS) to make the tax system easier to navigate, where possible.

Top slicing relief and corresponding deficiencies

4.4 We are surprised that there is no discussion in the consultation document of the complexities in the existing regime of top slicing relief and corresponding deficiency relief. The document discusses only the method of calculating the gains, not the consequent calculation of tax on the gain brought into charge. We feel this requires clarification – for example, is the intention to retain top slicing relief and deficiency relief in any or all of the new scenarios?

4.5 We assume the lack of reference to these issues is because the consultation is primarily aimed at the industry, rather than tax advisers. But we would stress that an holistic approach is needed.

Income gains

- 4.6 The consultation is also silent on the fact that these gains are chargeable to income tax and, except to the extent that they might be taxed under the remittance basis, are treated as savings income. This means that they might fall within the 0% starting rate for savings, or the savings nil rate (dubbed the 'personal savings allowance'); yet the 20% tax credit applied to gains from UK-based policies is non-refundable. This creates an unfortunate difference for those on low incomes who might benefit from those tax advantages if their savings were held in a different type of investment. It does seem somewhat unfair that the advantages of tax-free savings afforded by these recent changes in the law are not available for those people within their target income levels – particularly the starting rate for savings. There is also potential for anomalous results in terms of overall tax liability if the 100% allowance, option 2, is taken forward (see **example 2** at para 5.5 below, with calculations given in the appendix to this response).
- 4.7 As above, is there any intention to review the fundamental tax treatment of gains from life insurance policies, or is the intention merely to adjust the method of calculating the gains that might be brought into charge?
- 4.8 We feel this is a missed opportunity to achieve greater simplification and fairness if the changes are limited to calculation of gains.

5 Question 2 – Do you have any comments on the assessment of impacts, either generally or in relation to the specific options set out?

- 5.1 There might be a positive impact from the viewpoint of equalities legislation if a simpler and fairer method of taxing part surrenders is achieved. For instance, older people might become ill or disabled in later life and need to access capital from this type of policy on a gradual/phased basis – perhaps to pay for care in their own home, or for residential care. Avoiding unnecessary and unfair tax charges, not reflective of the economic gain on the policy, could therefore be to the advantage of policyholders in that type of situation. As noted above, we believe that the 100% allowance would achieve both simplicity and fairness. The first option of taxing the economic gain using an A/A+B formula would also be fairer than the current system, though not simpler to administer or comprehend.
- 5.2 In some cases, however, there is a risk of a negative impact depending on the timing of withdrawals. If the 100% allowance option is taken forward, which is the easiest to understand, it could mean that taxpayers suffer higher rates of tax after the original investment is withdrawn – for example, if the gain then takes them into the higher rate of tax. By contrast, the existing method of 5% withdrawals with chargeable events on the excess allows those with available basic rate band to make regular withdrawals over and above 5% but without creating a tax charge. This point may be best illustrated by way of an example (we assume for ease of illustration that the higher rate band is £34,000 each year, plus an £11,000 personal allowance, ie £45,000 before higher rate tax).

Example 1

- 5.3 Philip has income of £34,000 a year. He is in a London care home and requires specialist care, the fees for which are £750 a week (£39,000 a year). He therefore needs to raise £5,000 a year from his investment bond. After 8 years, his care needs increase, so the fees increase to £900 a week (£46,800 a year), so he needs to take out £12,800 in years 9, 10 and 11. The original investment in his bond was £60,000.

	5% regime	100% allowance regime
Years 1-8, treatment each year of £5,000 withdrawn	£3,000 falls within 5% allowance £2,000 is a chargeable event, but falls within the taxpayer's basic rate band – so no tax due	£5,000 a year falls within the 100% allowance each year, so no tax due
Year 9, £12,800 withdrawal	£3,000 falls within the 5% allowance Chargeable event is £9,800 – within the basic rate band, so no tax due	£12,800 falls within the 100% allowance, so no tax due (Note, total withdrawals are now £52,800 v £60,000 invested)
Year 10, £12,800 withdrawal	£3,000 falls within the 5% allowance Chargeable event is £9,800 – within the basic rate band, so no tax due	£7,200 falls within the 100% allowance, so no tax due on that portion £4,600 is chargeable, which falls within the basic rate band, so no tax is due
Year 11, £12,800 withdrawal	£3,000 falls within the 5% allowance Chargeable event is £9,800 – within the basic rate band, so no tax due	Full £12,800 is chargeable income. So total income is £34,000 + £12,800 = £46,800, so higher rate tax on £1,800 is chargeable (subject to top slicing relief*)

Note: the bond would of course have to have produced sufficient return to fund the year 11 withdrawal. But depending on income levels/withdrawals, this illustrates that some tax could be due in certain circumstances when using the 100% allowance basis as compared to the existing rules.

** As noted above, we cannot see from the consultation that top slicing relief would be removed under the proposed rule changes – this needs to be confirmed when HMRC issue their response to the consultation.*

- 5.4 A further example would be that someone entitled to the starting rate for savings or the savings nil rate might miss out on the benefit of the notional tax credit on life policy gains if the 100% allowance route is chosen. This would make the A/A+B method look more attractive.

Example 2

- 5.5 Suppose we have a pensioner on a pension of £14,000 per year and with a life policy investment on which premiums of £21,000 have been paid and which is now worth £30,000. Suppose further that the pensioner decides to withdraw money from the life policy at the rate of £10,000 for each of three years and that the policy does not gain in value over the three years. The total chargeable event gain is £9,000. The economic gain approach (option 1) will spread the gain equally over the three years while the 100% allowance approach (option 2) will put the whole gain in year 3. Assuming the allowances and rates for 2016/17 apply for all years, we believe the calculations would be as shown in the appendix at the end of this document.
- 5.6 In summary, those calculations show that with option 1 the aggregate tax liability across the three years is nil but with option 2 it is £1,200. This is because spreading the gain makes better use of the starting rate and savings nil rate bands, with the tax credit from the life policy gain essentially ‘franking’ the tax due on the individual’s pension income. This is a taxpayer of modest means who might, as in example 1 above, be using the money from the life policy to fund care home fees.
- 5.7 So although the 100% allowance is simple and moves to tax only economic gains, it is not without some disadvantages. If the 100% allowance is therefore chosen as the preferred option, providers must flag up the above outlined potential for tax liabilities to arise further down the line. The tax problems raised in the above examples might be mitigated by policyholders cashing in ‘mini policies’ within a main policy which is segmented, such that they are making full surrenders of segments rather than partial surrenders of several policies. This makes it important for providers to check the policyholder’s intention when instructed to make a part surrender and to highlight the potential for different tax treatment depending on which option is chosen.

6 Question 3 – Are there options beyond the three presented in this document that would better meet the desirable outcomes including ensuring that disproportionate gains could no longer arise?

6.1 We have no further options to suggest.

7 Question 4 – For each option, do the insurers' current reporting rules require amendment in any way?

7.1 No comment.

8 Question 5 – What costs would insurers have to incur, for each option in:

- Changes to their current IT systems to allow gains to be calculated and reported on each basis,
- Advice to policyholders on the change to the tax rules, and
- On-going costs in support of the changes.

8.1 We do not comment as to the costs insurers would have to incur, but on the second bullet, we think that insurers would have to make clear to policyholders the changes in the rules – whichever option is chosen going forward. This could perhaps be achieved at little cost through inclusion of some wording with annual policy valuation statements, which we assume are sent to policyholders in any event. It would be helpful to agree some standard, plain language, wording for insurers to use so that policyholders receive clear and consistent messages. A programme of including this information with policy statements after the changes are implemented would also notify all policyholders of the changes, not just those accustomed to making regular withdrawals.

8.2 Insurers should also flag up changes in the tax rules to policyholders when they make a withdrawal and make it clear in any statement sent at the time of withdrawal what the tax consequences and reporting requirements to HMRC might be.

9 Question 6 – What possible effects would each option have on the market for life insurance products?

9.1 No comment.

10 Question 7 – What possible extra burdens would each option place on policyholders, and how might each option affect policyholder behaviour?

10.1 Whichever option is chosen, the change in the rules would place a burden on policyholders to understand the new system and its potential impact on them. This might come at a cost if

policyholders are minded to seek advice, either from a financial adviser or a tax adviser (or indeed both) on the changes.

- 10.2 The 100% allowance model might have some impact on existing policyholders, as illustrated in our example above, but we do not foresee it having any immediate impact on *policyholder* behaviour (though we make no comment on whether it would drive insurers to consider their product offerings).

11 Question 8 – What possible tax avoidance risks does each option present, and how can these be countered?

- 11.1 It is possible that the 100% allowance model could drive policyholders to become non-resident before the policy matures, meaning a loss of tax to the Exchequer; but a similar position applies for capital gains and an equivalent to the temporary CGT non-resident provisions (s10A TCGA 1992) could perhaps apply.

Taxing the Economic Gain

12 Question 9 – Are there any circumstances in which the $A/(A+B)$ formula would not give rise to an appropriate proportion of the policy's economic gain?

- 12.1 We do not believe there are.

13 Question 10 – Is there a fairer method of calculating the part of the premium that would be deductible from the amount withdrawn when calculating the gain?

- 13.1 We do not believe so.

14 Question 11 – Policyholders would need to request a policy value in order to know what gain any part surrender or part assignment will give rise to. Are there any difficulties for policyholders and insurers in accessing this information?

- 14.1 If this option were to be implemented, we would point out there is an issue over what valuation figure should be used for 'B' in the $A/(A+B)$ calculation. Is the 'B' figure the current remaining value in the policy, or is it the current *surrender value*? These may be two different figures – the surrender value taking into account charges, etc. With 'with-profits' type policies, the surrender value may be very different to the current valuation, depending on allocation of terminal bonuses – these may be estimated in a current valuation, for example, but recalculated if the policy is surrendered. A 'Market Value Reduction' might also be applied on surrender of a with-profits policy, resulting in a marked difference between a current valuation and actual proceeds received.

- 14.2 The information to policyholders would therefore need to be very clear as to which valuation they are supposed to use. In fact, rather than just advise policyholders of valuation figures and leave them to calculate the gain, we would recommend that insurers should calculate the gain to be reported and to advise the policyholder what their obligations are to HMRC (how to report it and how any tax might be collected).
- 14.3 Whilst we prefer the 100% allowance option for simplicity, we think this is the second best of the options proposed in terms of fairness in taxing only economic gains (except in the case where there may eventually be an overall loss on the policy, but due to fluctuations in value on earlier part surrender, a gain may have been previously taxed). But we understand that policy providers would have to undertake system changes, for instance to provide the 'B' valuation to calculate the change (and, if our recommendation is followed above, to calculate the gain itself). One possible straightforward way around that problem is to allow the taxpayer (or insurer, if calculating the gain for the policyholder) to use the most recent regular valuation, provided it is not more than twelve months old, so that a special valuation is required only in the exceptional case that the policy is not valued annually.

Deferral of Excessive Gains

- 15 Question 12 – In the example provided, the pre-determined amount, above which gains are deferred is 3%. What would be the most appropriate way to set this pre-determined amount?**

15.1 No comment. We do not wish to see this proposal taken forward.

- 16 Question 13 – Are there any circumstances in which this option would not give a reasonable result?**

16.1 We do not think it is appropriate to continue with a model which taxes anything other than the true economic gains of the policy. Moreover, this proposal is likely to be incomprehensible to all but the most sophisticated investor, so even with a cap on taxing 'gains', we do not think it is an acceptable way forward. It does not seem appropriate in any circumstances to have the possibility of a tax bill arising where the true position is that there has been little or no real economic gain, or even a loss.

- 17 Question 14 – Assignment of a policy may not crystallise all or even part of the deferred gains on that policy. What is the best way to ensure that assignees are fully aware of these deferred gains and the circumstances in which they may be crystallised?**

17.1 No comment. We do not wish to see this proposal taken forward.

Appendix - Example 2, calculations

	Year 1	Tax	Year 2	Tax	Year 3	Tax	Total
<u>Option 1</u>							
Pension	14000		14000		14000		
Less PA	11000		11000		11000		
Chargeable at Basic Rate	3000	600	3000	600	3000	600	
Chargeable Event Gain	3000	0	3000	0	3000	0	
		600		600		600	
		Nil		Nil		Nil	
Credit for tax on Chargeable Event Gain							
Net tax liability							Nil
<u>Option 2</u>							
Pension	14000		14000		14000		
Less PA	11000		11000		11000		
Chargeable at Basic Rate	3000	600	3000	600	3000	600	
Chargeable Event Gain	0	0	0	0	9000	1200	
		0		0		1800	
Credit for tax on Chargeable Event Gain							
Net tax liability		600		600		Nil	1200