TAX AND DUTY AFTER THE BUDGET*

The talk I am supposed to give to-day is entitled "Tax and Duty after the Budget". That gives me a very wide scope. I might, for instance, give a stirring address on the duty of the life assurance industry to pay S.E.T. for its agents. But I imagine that you would like me to talk about the life assurance aspects of the Budget, in relation to income tax, surtax and estate duty.

One thing I would like to stress is that the Bill, which many of you have studied very closely, is not necessarily in its final form and what I am to say to-day concerns the Bill as it was published. Certain clauses, I am sure, are going to be amended and it is obviously impossible to say exactly what the law will be, until we see the Bill in its final form.

Now, I think the Bill has two main objects in relation to life assurance. First, it is designed to restrict the use of life policies as a haven for surtax purposes and whilst it by no means restricts this entirely, it certainly goes a long way to remove many of the particular advantages which life assurance, or what I might call "so-called life assurance", had for surtax purposes. The second main object of the Bill is to restrict, and here I think to restrict very severely, the use of life assurance as a part of a "death-bed" arrangement to avoid estate duty. It probably does not affect very much what might be described as long term minimisation of estate duty, but it certainly is designed to prevent the type of scheme whereby a man could carry through the scheme and die cheerfully, if he liked, a few days later and have saved his estate a large sum of money in duty.

Now I think if one keeps those two objects in mind, one will understand to some extent what they are doing.

Actually, there are six changes in the law which affect life assurance and if I can just list them I will then try to elaborate each of them.

The first one is that life assurance relief for income tax purposes is only allowed on policies taken out after the Budget which are within the definition of "qualifying policies". This restriction does not affect policies taken out in respect of insurances made before the Budget so long as the policies are not

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* This is the transcript of a tape-recorded talk. The talk was first given by Professor G. S. A. Wheatcroft, M.A., on 11 May, 1968, and the tape recording was repeated for members of the Association on 21 May, 1968.

varied in any way.

Secondly, a surtax charge is imposed on gains made on a policy taken out after the Budget, unless it is a qualifying policy.

Thirdly, there is a tightening - a considerable tightening - of the already not very severe restrictions on borrowing on policies to pay premiums.

Those are the three tax changes. Then there are three duty changes. The first duty change, which we might call the fourth change in the Budget, is the extension from five years to seven years of the period within which a gift becomes dutiable on death.

The next one, the fifth, is that there is a more restricted definition of "normal and reasonable expenditure" for the estate duty exemption for gifts made which are part of the normal and reasonable expenditure of the deceased.

Finally, and probably this is the most important, all gifts, and property representing gifts, will in future be aggregated with the free estate of the deceased and any other property passing on his death, in respect of people dying after the Budget, even though the deceased never had an interest in the subject-matter of the gift.

Let us deal with each of these in a little more detail. First of all, life assurance relief - that is, Clause 16(1)(a) of the Bill. This tells us that relief from tax under Section 219 should be granted in respect of the premiums payable under a policy of life assurance only if the policy is a qualifying policy within the meaning of Part I of Schedule 9 but this is subject to three exceptions.

Sub-clause (2) tells us that nothing in this Section or Schedule 9 shall apply to a policy of life assurance, the only benefit secured by which is the payment on an individual's death of a sum for the repayment of any debt then outstanding under a mortgage of his residence or of any premises occupied by him for the purposes of a business being a mortgage the principal amount secured by which is repayable by annual instalments. This is really only for instalment mortgages and does not, of course, apply in any way to the ordinary case where you have a life policy which matures at the same time as a mortgage becomes due, that is to say, an "endowment mortgage".

The second exemption is in relation to sponsored superannuation schemes, and provided that one-half at least of the cost of the scheme is borne by the person or persons under whom the relevant office or employment is held (that means the employer) then nothing in Clause 16 or Schedule 9 applies to such a policy. The third exemption is that the restriction of life assurance relief only applies as respects policies of life assurance issued in respect of insurances made after 19 March, 1968. You must note the wording which may be material in certain cases throughout this Act; it distinguishes very clearly between insurances made and policies issued, so that an insurance where risk was assumed on or before 19 March is all right even though the policy was not issued until afterwards.

Those are the three exceptions and we just ought to look briefly at Schedule 9. I do not want to go into it in great detail because if I do I shall run well over my time, but Schedule 9 deals with policies by types. First of all, we have some rules about whole of life policies, then about term policies, then about endowment assurance policies, and then about friendly society policies which are not treated by this Act at all - at least, any friendly society policy is a qualifying policy provided it complies with the 1966 Act which you remember restricted quite severely the friendly society type of assurance policy, and an industrial assurance policy is also a qualifying policy on certain conditions. And then, finally, there is a classification of family or mortgage protection policies. The general principle appears to be that so long as a policy runs for 10 years or more and is not surrendered within that time, it is all right, subject to various restrictions on the amount of premiums and as far as I can see (although you may differ) these restrictions do not worry what might be described as "normal business" for whole life or endowment assurance and it seems to me that very little restriction is placed on the normal policy. Term assurance is restricted if the period is more than 10 years. If it is less than 10 years there is only one proviso which affects it. It must provide that any payment by reason of its surrender during the period is not to exceed the total premiums previously paid thereunder and I do not think I personally have ever seen a term assurance that did so provide. But possibly there are some. There should be a considerable market in the next few years for people who have already insured a five-year term, either for themselves or in connection with a variation of trust, and they are now in the new estate duty rules wide open for the last two. Of course, this does mean in many cases the company must be offered and duly accept the extended risk, and the medical examination may preclude this. Subject to that, I would think that a large number of people have made transactions in the last few years

which they now find were in theory watertight under the laws as they then stood with the aid of term assurance, but now are no longer so.

Then there are some rules at the end of Schedule 9 which I am a bit reluctant to examine in detail at the moment because I suspect that these may get varied. There is a rule which says "in taking account of the premium restrictions you can disregard an extra premium because of an exceptional mortality risk". So when the actuary says he will not take it without an extra premium you do not have to worry that you are now going outside the premium limitations. There is also a provision about "connected" policies which broadly treats any policy taken out for the same length of time as another policy as "connected" with it, and as having to be read with it for the purpose of ascertaining if it is a qualifying policy.

Then there are various rules about premiums paid out of sums due under previous policies largely where there is an option or something of that kind to take a paid-up policy, and then finally there is a clause (which you will have to look at rather carefully when the Bill is passed) on variations of policies. It is a difficult question at the moment to see whether, if you do some variation of a pre-19 March policy, this loses any of its exempt status and it is also difficult to see what exactly is the effect of a variation of a pre-Act policy. This again may be important under the estate duty provisions because, as we shall see, the total sum payable under all policies issued in relation to a particular death is the guiding factor for an exemption. In some cases it might well pay the assured to decline the next bonus distribution. Query - Is that a variation? I think we shall have to consider that problem when we see the Bill in its final form.*

The next change is that surtax is charged (and if the policy is held by a close company, a shortfall charge is imposed) on what is here called gains arising on certain policies. Broadly, here we are in the same class as before; a pre-Budget policy is all right, a post-Budget policy is within this charge unless it is a qualifying policy and here we add in capital redemption policies and the surrender of life annuity contracts. Now the rules for calculating the gains are a little complicated. They are in Part 2 of the Schedule, which first of all tells us what is

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* The problem raised by the speaker loses its force now the Chancellor has conceded the point on marginal relief over £25,000.

a chargeable event and this broadly is anything that brings the money in (death, maturity, surrender or assignment of the policy) and once a chargeable event occurs, there is to be treated as a gain arising on the policy, a sum which is broadly calculated by taking the surrender value of the policy the day before the event happened. That is to say, you disregard the fact of death but you take the surrender value, so to speak, the moment before death, and/or the sum received, and then you deduct from that the premiums that you have paid and the balance is the chargeable gain. So that there is very little profit unless you are within one of the exceptions for a surtax payer to take out a policy which is not a qualifying policy.

There are various special provisions including, I think, the rather complicated "top slicing" provision of the 1963 Act which relates to lease premiums and which enables you to spread your gain over a number of years. That is to say, you can in fact, supposing the number of years is six, find out what extra surtax would be payable on 1/6th of the gain and having found that tax you multiply it by six. This is to avoid bunching the whole into one year. There will be few cases where anybody will deliberately put themselves into these provisions. I think they are <u>in terrorem</u> and in future it will only be the accidental case that falls into the mischief of these provisions.

The third item is the tightening of the restrictions on borrowing to pay premiums. I expect most of you in your careers have had a look at Section 241. Actually, for many practical purposes it has been a dead letter. I remember coming across a case in my early career where 241 applied, but the exemption in 241(3)(d) allowed you to pay interest, or rather to get a surtax deduction for interest, on borrowed money applied to, or towards, the payment of premiums under a contract of insurance which assures throughout the term of the contract a capital sum payable on death, if neither the amount of the first premium under the contract, nor the amount subsequently payable by way of premiums thereunder in respect of another period of 12 months exceeds 1/8th of the capital sum payable on death. That was the old restriction and any reasonably longish policy was perfectly all right. Now that is altered quite substantially and here we have Clause 16(1)(c) of the Bill. That tells us that Section 241(3)(d) is to be amended so that it does not apply to any interest or other sum unless it is shown to the satisfaction of the Board that it is exceptional for the individual in question to apply borrowed money to or towards the payment of premiums to which that provision applies and that no such money has been so applied by him in any of the three years of assessment immediately preceding that in which he so applies the money. So that, broadly speaking, this is the death of the borrow-all and I

do not know that many mourners will go with it to its grave - at least, not probably of the more serious people. The exemption in Section 241(3)(e) still remains but there the interest allowed is limited to £100 per annum, and so it is not going to be of great importance as an avoidance device. The test here (as to policies taken out before or after the Act) is whether the interest or other sums payable in respect of money borrowed is payable after the Budget, so that it does not matter whether the policy is an old one or a new one - if you borrow after the Budgetto pay premiums directly or indirectly, then you will get no surtax deduction for it unless you can show these very exceptional cases or you are within Section 241(3)(e).

Those are the three income and surtax provisions and we proceed to have a look at the estate duty ones. We start with Clause 30. Clause 30(1) simply substitutes the words "seven years" in all the estate duty provisions which formerly had five years in them. That applies to the general exemption for gifts, to Section 43 (FA 1940 cases) and all the other provisions where there was a five-year period and now it is seven, except that this does not apply to a period beginning on or before 19 March, 1963. That is to say, anybody who has done his five years by 19 March of this year is not affected by the change, but anybody who is even a day short is affected by the change so that there can be a significant difference here between a person who died on 19 March and a person who died on 20 March, if a gift had been made just five years before his death. Under the old law there were quite substantial reductions on gifts after the first two years of the period - 15% in the third year, 30% in the fourth year and 60% in the fifth year. Under the new law, these reductions are still there, but they take effect two years later. That is to say, you are on full risk for four years, you get a 15% reduction in the fifth year, 30% reduction in the sixth year, and 60% reduction in the seventh year, but if you have already got a period in under the old law which gave you a reduction, you do not lose it; you hold the reduction you had on 19 March until you get a better one under the new law. So that if you had a 15% reduction, if you died on 19 March, you would stay with a 15% reduction for the remainder of your period until you get your 30% reduction in the sixth year. Similarly, if you had a 30% reduction you would stay with it until you get a 60% reduction in your seventh year. I don't know that there is very much more to say on this except, perhaps, to draw attention to its effect on life policies which have been kept up. As you probably all know, when a policy had had five or more years' premiums paid, the dutiable slice of the policy was found by

a fraction which had 395 as a numerator and 100 N as the denominator, when N was the number of premiums paid. If it was just five years it was 395/500. This was the effect of the 15, 30 and 60% reductions applied to the earlier premiums. If you had 10 years' premiums paid you would have 395/1000 of the policy and that fraction of the policy would be dutiable. Well, now the formula has changed and for the characters who now pay another premium they will now have six premiums dutiable, instead of five as before, so that the fraction will be 495/100 into N + 1 and the year after it will be $\frac{595/100}{N + 2}$. As I cannot reproduce a blackboard on the machine I am afraid you will have to take my mathematics as given. But the effect is this. Take a person who has paid five premiums; if he dies now and he has not paid another premium, 395/500 will be dutiable. If he pays another premium and then dies it is 495/600. If he pays yet another premium and dies it will be 595/700. The result of this is that the dutiable slice rises with the payment of the next two premiums. It will then begin to fall again because more and more of the policy will be going out of duty. It does not make a very big difference, but an appreciable difference in some cases. I have had some correspondence with the Chairman of the Board of Inland Revenue on this subject and he simply says "Well, a chap's made another gift and therefore ought to pay some duty upon it." And, of course, that argument has certainly some merit, and I wrote back and told him that I could see his argument, but I didn't think that the characters who were affected by the increase would see it, and this remains to be seen. That is the one case I think where the situation of the person after the Budget is worse on the question of the five year to seven year charge than before; that is to say, of course his situation is worse as he now has got to do more years, but the actual amount that is payable in this particular case - the amount on which duty is chargeable - may increase slightly.

Now we turn to normal and reasonable gifts, covered by Clause 32. I do not think the marriage settlement exemption which also has been cut down will affect this industry very much, but "normal and reasonable" does, and a new definition has been given. It tells us that Section 2(1)(c) of the Finance Act, 1894 - that is, the section that charges gifts with duty - shall not apply to a gift if it is shown to the satisfaction of the Board to comply with three conditions. First, that the gift was part of the "normal" expenditure of the deceased - that is the old wording except that the word "reasonable" is excluded. Secondly, that the donor made the gift out of his income and, thirdly, that, after allowing for all

gifts forming part of his normal expenditure, the deceased was left with sufficient income to maintain his usual standard of living. There is one small point here which I hope will get altered in the Bill. It was held in a Northern Ireland case that the old normal and reasonable exemption for gifts could not be attacked in the courts. The wording was the same as it is here. It had to be shown to the satisfaction of the Board and if they were not satisfied there was nothing you could do about it. The words "shown to the satisfaction of the Board" appear in quite a few places in this Bill and I imagine that there will be some pressure to have that particular point challenged in the courts if the subject disagrees with the construction the Board have put upon his action. As it stands it was only a case in the first instance, but unless that case is overruled I suspect that the Board will be unchallengeable in respect of any decision made under this provision. The words "normal expenditure" obviously connote some degree of regularity and so it may be difficult to get any exemption for a single gift under this heading.

The words that "the gift was made out of income" do not, I think, mean that a character has got to keep his left-hand pocket labelled "income" and his right-hand pocket labelled "capital" and make sure he pays it out of his left-hand pocket. I would think that this is in very much the same case as, say, we take section 169 of the Income Tax Act - it will be sufficient if you will look at the total amount of the income and the gift. But the real snag, I think, about this definition comes in the third condition, that after allowing for all gifts forming part of his normal expenditure, the deceased was left with sufficient income to maintain his usual standard of living; and I think that must mean his after-tax income, and therefore the character who makes gifts which he wishes to have allowed after his death as normal and reasonable expenditure, will not get them allowed if he has been spending money out of capital to maintain himself in those years. And this, I think, will rule out quite a few characters who would like to have the benefit of this exemption. Of course, this exemption is particularly important when we are considering, say, life of another policies where the person who is going to die makes gifts of money, does not keep up the policy, but makes gifts of money, or indeed, pays the premiums (either will do) and wishes to say that the policy is in no way dutiable because the payments he made, either of money or in respect of the premiums, were normal and reasonable expenditure. And in any sizeable case, I think it may be difficult to comply with this last condition. And pausing there for the moment I would think it is now much better to make gifts of money and let the beneficiary keep up the policy, than to pay the premium, but this is something we shall have to think about.

I have left the worst to the end and here we have Clause 33, which deals with non-aggregation. Clause 33(1) just sweeps it away and says that any property which passes under Section 2(i)(c) (that is, the gift section) is deemed to be property in which the deceased had an interest whether he had or not. Just observe, however, that it only applies to property which passes under Section 2(i)(c) and therefore I think that the widow's annuity under a pension scheme, which you may remember was brought into the old 1954 aggregation scheme, will not be affected by this because it does not pass under 2(i)(c) - it passes under 2(i)(d). There are then some clauses, however, to make it clear that if liability arises to estate duty under several provisions of the law of which one is 2(i)(c), then broadly - it is the usual kind of revenue provision - the biggest possible part is deemed to pass under 2(i)(c) and to be aggregable, and the smallest part is left for the other passing. Then we have to come to the exemption clause for past transactions and this is one which I am fairly sure is going to be amended. Clause 33(6) says that the section shall apply in the case of death after 19 March, 1968, but it shall not apply to property passing on the death under Section 2(i)(c) by virtue of Section 34 of the Finance Act, 1959, where there again are two conditions:

(a) The gift was a gift of rights under a policy of insurance issued in respect of insurance made before 20 March, 1968, and

(b) The total amount or value of the sums payable or other benefits arising under all policies of insurance related to the death which were issued in respect of any insurance made before 20 March, 1968, does not exceed £25,000.

It then says that a policy is related to the death if any gifts of rights under the policy form part of the property passing on the death. Now this Section does not, I think, go as far as the Revenue intend because, as I see it, it gives no exemption at all to a single premium policy because a single premium policy never was caught by Section 34 of the Finance Act, 1959 - that was the Section which caught payments to keep up a policy and, of course, you cannot keep up a single premium policy. That was caught as a straight 2(i)(c) gift and I think, strictly speaking, the same argument applies to the first premium on a policy with annual premiums, because you cannot keep up a policy until the first premium is paid. Now I have had some correspondence with the Chairman of the Board on this and he tells me and, indeed, I

think it is clear from the circular issued, that he did not mean this exemption to be restricted only to annual premium policies, and that he did mean it to apply to single premium policies if they come within the £25,000 exemption, and that is one reason why I think this clause may be amended. It is very important, however, to observe that the exemption for benefits arising under £25,000 is related to the total benefits payable under all the relevant policies and not to the "dutiable slice". This has some very curious consequences. You have a man who say, on 19 March or even to-day, had paid premiums under policies and they were "with profits" policies. If he died to-day the total payable would be under £25,000. However, he dies a few weeks later by which time a bonus has been declared on the policy which has made it £26,000 or £25,001. He loses the whole exemption: And that is why I said earlier that it could pay some people to come and say to a company, "For heaven's sake, don't give me any more bonuses" and - query - is that a variation of your policy? It is also, I think, important to observe what I think is a point I would like to come back to on the question of retrospection, that a man who took his policy out in 1954 immediately after the passing of S.33 of the Finance Act of that year (with its changed conditions of aggregation between each beneficiary) may be caught under this. True, the dutiable slice may not be very big because he has paid a lot of premiums, but because the total amount payable under the policy exceeds £25,000 he is going to lose non-aggregation. And you can, of course, put a rather extreme case, where the free estate is, say, just £100,000 and a dutiable slice of this policy comes to about £8,000 and the result of this change is that the tax is 100% because it is on a margin. And that seems to be hard on the man who took his policy out in 1954 or 1955.

This really brings me back to the real basic issue here - how far, if at all, is it right for this sort of thing to be retrospective? It is very easy, particularly for a lawyer, to say "no retrospection". This is not what happened before. If you look carefully at the 1954 Act you will find that there was complete retrospection. That was, of course, designed to catch the character who had taken 20 separate policies out at £1000 each and they all got away because they were separately aggregable in the figure of £1000 which was then the basic minimum for estate duty. I have always taken the view that a person who is advising in the estate duty field must point out to his client that he will die according to the law at his death and duty will be chargeable in relation to the law at his death, and all the history of estate duty shows that you are not playing with the law as it stands when you carry out the transaction - you are

playing against what the law will be and, indeed, I myself regard the estate duty changes as purely temporary. They are I think purely a holding operation pending a complete change in estate duty and probably accompanied by a gift tax, which if this government manages to stay in for another two years it will probably bring in before it goes out. And then we shall see an entirely different look, and very little regard will then be had to transactions before the Act. It is merely changing the law for people who die after the Act, and I think is an important thing one must bear in mind in all future business. This Bill has underlined the advice that I mentioned before, namely, that it is quite wrong to consider estate duty law as unchangeable. I remember pulling the leg of Potter & Munro on their first edition when they published a precedent which they said would escape surtax - it was a precedent for a discretionary settlement which would escape surtax and estate duty for 80 years. I had a bet with them which they would not take - that long before 80 years was out the law would be changed. And I think that is the first point - whether we like it or not some element of retrospection in the sense that it applies to transactions before the Act is inevitable in this field. And so I think we come back to the much more difficult question "What kind of retrospection is reasonable?" Here I find myself rather at variance with the provisions of this Bill. First of all, as I have said, it seems to me quite wrong to make a major change which affects people who undertook transactions reasonably soon after 1954. I think that they were entitled to rely on the fact that Parliament said that certain kinds of policies were to be treated in a certain way. I do not think that sort of argument applies to some characters who did transactions in the last two years. They knew, or ought to have known, that the law might well be changed. That is the first point.

Secondly, I think the £25,000 is a bad figure. We all know that the revenue started putting pressure on the life offices' associations a good many years ago to do something about what are known as "back to back" policies and they threatened legislation if they did not and the Life Offices' Association established a rule (which I think, as we all know, was frequently honoured in the breach) that in such cases £50,000 was to be the maximum sum assured, and if there is going to be a figure in this exemption I would think £50,000 is the right figure and not £25,000. I am not worrying now so much about the life companies or the brokers but the people who were told that £50,000 was respectable but anything over that was going a bit near the line. It seems to me wrong that people who did confine themselves to what they regarded rightly or wrongly as the respectable figure should be penalised.

I have already made the point of the policy which increases in value with bonuses or if a unit linked policy. It seems very hard that you should suddenly go over the line because your policy has got a bit more valuable and I further made the point that I think it quite wrong that a change of this kind should affect people who took their policies out in 1954, or thereabouts. I would hope that on grounds like these some considerable exemptions would emerge during consideration of the Bill, but I think this is only hope.

N.B. Since Professor Wheatcroft gave this extempore talk some modest concessions have been made by the Government. Marginal relief is after all to apply to the case of the policy slightly exceeding £25,000 and there may well be others. Nevertheless, it is not expected that the concessions will be very substantial.

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