SOME TAX SIDELIGHTS ON THE FINANCE ACT, 1968*

My talk this evening is entitled "Some tax sidelights on the Finance Act, 1968". The word tax is there to indicate that, in order to limit the ambit of the subject, I will not be dealing with the estate duty changes, and I am, in fact, confining my attention to Section 16 and the 9th Schedule. The words "Some sidelights" indicate that I am not here attempting a systematic description of the provisions as a whole, as I am sure that by now we have all had our fill of articles and addresses doing just that. Maurice Mackrell and I have added our contribution, in the form of a regrettably lengthy article which has appeared in the "British Tax Review", to the heavy burden of articles which we all have to read, just in case there lies buried, somewhere in the latest article, one small but important point which has not yet emerged from the earlier articles.

This evening I am rather going to concentrate on examining some general principles and going into depth on a couple of important but somewhat random points - or sidelights. For the most part, I hope to show that some of the things which many people may feel are highly complicated are, in fact, quite simple. In certain other respects, however, I shall try to show that some other things which appear at first sight to be simple are, in fact, on closer examination, highly complicated.

Perhaps the ultimate in simplification was suggested to me by one of our outside Directors whom I bumped into shortly after the Budget Speech, and I am sure many of you have had similar problems with lay Directors. He said to me: "I see in the papers that there are some new rules for life assurance policies which the journalists seem to be making heavy weather with. Could you please explain to me in one sentence just what it is all about?". There then followed a fumbling and incoherent account by me of what the changes appeared to be, which took up a considerable part of the morning.

When sitting down with the text of the Act to look for some sidelights for this evening, however, this request by our Director came to mind again, and I am now sorry that I did not think of replying to him as follows:

"Where in the case of any policy which came into force or was materially varied after 19th March, 1968, the premiums either were

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* The text of an address given to the Association on 30 September, 1968, by Mr. M. A. Weinberg, B.Com., LL.M. (Managing Director, Abbey Life Assurance Co., Ltd.)

not by the terms of the policy payable for at least 10 years, or were in fact discontinued within 10 years, other than upon death, then the excess of the proceeds (or in the case of payment on death, the surrender value immediately before death) over the premiums paid is chargeable to surtax, at a marginal rate determined by including in total income that excess divided by the number of years the policy was in force, and in the case where the premiums were not by the terms of the policy payable for at least 10 years, the premiums also do not qualify for income tax relief."

Life assurance has two distinct purposes - to provide financial protection against the premature death of the life assured and/or to provide a form of long-term investment. Most policies, of course, provide a combination of these two benefits.

These two purposes may be rolled into one by saying that the object of every person who takes out a life assurance policy is to make a profit if a certain event occurs (generally death before maturity of the policy or maturity of the policy before death) - to get back more than is paid in as premiums. Of course, the person may hope that one of the events, namely death before maturity, does not occur for a long time, but the object of buying life cover is to make a profit if death does, unfortunately, occur early.

The significant difference between the protection and the investment elements of a life policy is this. As far as the protection element is concerned, the earlier the event occurs, the greater the protection profit will be - that is, the excess of the sum assured over the premiums paid for the protection. As far as the investment element is concerned, the later the event occurs, the greater the investment profit will be.

Life assurance - whether directed towards protection, investment, or both - has always enjoyed tax advantages in Britain. When a person invests money in a life assurance policy he is entitled to income tax relief on his premiums which may, within limits, effectively reduce his real outlay by as much as 16½%. The premiums are then accumulated by the life office in a fund which bears no surtax and whose income is taxed at a rate lower than the standard rate of income tax, despite the fact that the policy proceeds, whether paid on death, maturity or surrender, were free of tax. Viewing it as a form of protection, the effect of these tax advantages has been to lower the effective cost of the protection. Viewed as a form of investment, the effect of the tax advantages has been to contribute considerably to the investment attractions of life assurance policies. The most popular policy in Britain is the endowment policy, under which only something like 10 to 20% of the premium provides the life cover and the remainder is ploughed into the investment benefits, so that it is fair to conclude frankly that the primary effect of the tax advantages is to improve the investment attractions.

This favourable tax treatment has undoubtedly stimulated the growth of life assurance as a long-term savings medium, and this, in turn, has enabled the life assurance companies to play a valuable role in financing capital investment and in stabilising the economy through encouraging long-term savings. At the same time, the surtax advantages in particular have encouraged the development of a number of specialised types of contract, and the use of life assurance in special situations, with the primary purpose of avoiding surtax.

The object of the Finance Act, 1968, is to remove the surtax and income tax advantages enjoyed by a number of offending schemes, while at the same time preserving all the tax advantages of life assurance contracts used either purely for protection or as a long-term regular savings medium.

I think the draftsmen of the Act are to be congratulated for the efficiency with which they have set out to achieve this objective. The complexity of the 9th Schedule is not the fault of the draftsmen but is a reflection of the wide range of policies devised by life offices over the past two centuries and of the commendable efforts of the Inland Revenue as far as practicable not to hit the existing range of bona fide plans on the market - and it is at the same time a back-handed compliment to the likely ingenuity of the life assurance industry in devising new plans to take advantage of any potential gaps in the legislation.

I am sure that everyone who read the Hansard reports of the debates by the Standing Committee will wish to pay some tribute to the attitude of the Treasury towards life assurance. The Financial Secretary to the Treasury stated repeatedly that there was no intention to penalise normal forms of life assurance, and firmly expressed the opinion that it was right to exempt long-term life assurance policies from surtax. He also said, and I quote: "I firmly believe that the industry and economic activities of the country should not be tailored to meet the convenience of the Revenue - rather the other way round".

Having regard to the complexity of the subject-matter, it is hardly surprising that there are some areas of obscurity and that there are some areas where the provisions of the new Act are unfair or unreasonable. Although I shall touch on some of these, it is not my purpose to set out a list of these points here. I would like to express the hope, though, that the insurance industry will co-operate in high-lighting these points of detail where there is some obscurity or unfairness with a view to persuading the Government to sort them out by amending legislation next year, rather than by carping at the principles underlying the legislation, which I personally consider quite reasonable. In retrospect, I think it was perhaps unfortunate that so much of the debate in Parliament was concerned with attempts, which were doomed to fail, to get the Revenue to modify the new rules in areas where the legislation was on particularly strong ground, such as in relation to borrow-all policies.

There is little to say on the subject of policies designed primarily for protection, as the legislation does not hit at them at all - except by a side-wind, where a rule designed to prevent a policy being taken out for investment purposes getting an undue tax advantage happens incidentally to hit as well at policies taken out primarily for protection. I have considerable sympathy for the Revenue here, as it must have been awfully difficult to design legislation which did not hit legitimate policies as well in this way. In many cases, the life assurance industry has a simple remedy, because it can devise new policy forms to give the same result in a way which is not hit by the new rules, and in those cases where this is not practicable, it is to be hoped that the Revenue will be sympathetic to requests for amending legislation. There is a case - which was this year rejected by the Treasury - for giving the Revenue a general power to exempt special forms of policy from the tax penalties. Clearly, the Revenue would not wish to have the responsibility of deciding which policies were socially desirable and which were not - this is clearly Parliament's job - but it ought to have been possible to devise a provision which gave them a power of dispensation in respect of proposed forms of policy which breached the new rules only by reason of some technicality.

The 9th Schedule is plainly concerned primarily with policies designed for investment purposes. Here the circumstances in which a policy is to continue to enjoy tax advantages can be stated very briefly: the policy must represent a <u>long-term</u> regular <u>premium</u> plan. Note that there are two elements: <u>long-term</u> (meaning, simply, at least 10 years) and <u>regular premium</u> (since lump-sum or other irregular investments, however long-term, are not to enjoy tax advantages).

Looking for the logical thread running through the 9th Schedule, one sees that the provisions fall into three categories - call them sub-threads - although these three sub-threads are often interwoven in the same paragraph.

<u>Sub-thread (a)</u>: Provisions which lay down the basic principle that the tax advantages shall be removed from investment policies which are not taken out and kept up as long-term regular premium plans. These are generally the most straightforward provisions.

<u>Sub-thread (b)</u>: Provisions designed to prevent people taking advantage of the flexibility of life assurance so as to get the tax advantage for policies which are not taken out and kept up as long-term regular premium plans. It is under this sub-thread that we find many of the complicated rules about substitutions and variations.

<u>Sub-thread (c)</u>: Provisions designed to preserve the tax advantages for policies (generally special existing types of policy)which, although innocuous from the Revenue point of view, are hit by the new rules, usually by the sub-thread (b) anti-avoidance provisions. Some of the rules relating to substitutions and variations also fall under this sub-thread.

It is worth bearing in mind at this stage that, for all their length and complexity, the provisions of the 9th Schedule were aimed at only two main classes of schemes- which had recently become popular - the single premium policy and early paid-up policies.

Judged solely from the point of view of surtax-free roll-up of income, single premium policies were the simplest and most efficient, since the whole amount was transferred immediately from the policyholder to the insurance company. However, the income tax relief tended to be severely limited by the operation of the rule that the premium on which relief is available is limited to 7% of the sum assured. Since the premium under a single premium bond (as they have recently come to be known) is something like 50% of the sum assured, the effective income tax relief tended to be limited to about 2% of the premium. As with other life policies, the proceeds were surtax-free.

<u>Early paid-up</u> policies were endowment or whole life policies taken out with the intention that only two or three annual premiums would be made and then converted into paid-up policies. Here the transfer of the money from the hands of the policyholder into the surtax-free hands of the insurance company was spread over the effective premium-paying period, with a corresponding deferment of the full surtax saving advantages, but this was usually compensated for by the fact that the policy is even more tax-efficient as regards tax relief, available for anything up to 16½% of each premium. The early paid-up policy is, of course, a near relative of the single premium policy, with the money being transferred to the insurance company in two or three instead of one instalment.

The rules for qualification and disqualification, as well as the anti-avoidance provisions, are all aimed at single premium or early paid-up policies or at the different guises which they would assume in the future in the absence of special provisions.

The most tax-efficient (or, according to your viewpoint, diabolical) policy, however, was the "borrow-all" policy, which also took the form of an endowment or whole life policy taken out with the intention that only two or three annual premiums would be met out of the resources of the policyholder. The subsequent premiums would be met from borrowed money and, because the loan interest was, within limits, an allowable deduction for tax purposes, a policyholder could in this way "gear up" his surtax advantage by getting surtax relief on the interest, while the loan was invested surtax-free, and would furthermore continue to receive income tax relief each year on what was in reality the same amount of money being rolled over throughout the term of the policy as the annual premium. It should be noted that the provisions of the 9th Schedule are not aimed at borrow-all policies, which are dealt with by the amendment of Section 241 of the Income Tax Act contained in Section 16(1)(c). One version of the borrow-all plan is, however, effected: some brokers apparently used to recommend what they colourfully called "two pay - two borrow - then pup" (pay two premiums, borrow the next two, then make the policy paid up). The "pup" element of this type of plan is clearly taken care of by the provisions of the 9th Schedule.

Life assurance policies can be divided into four classes:

First, there are pre-Budget policies: If a policy is a pre-Budget policy, it falls outside the provisions of the Act and we need not concern ourselves with it unless someone varies it or substitutes another policy for it. At least until then it continues to enjoy income tax relief under the old rules and freedom from surtax on the proceeds.

Secondly, there are qualifying policies: These are policies which either are pure protection policies or satisfy the golden rule requirements of a long-term regular premium plan. These policies, unless they become disqualified, qualify as before for income tax relief and for freedom from surtax on the proceeds.

Thirdly, there are non-qualifying policies: These are policies which, for one reason or another, do not satisfy the golden rule requirements, generally because they are not by the terms of the policy long-term or do not provide for sufficiently regular premium payments. They are denied income tax relief - and, at the point, known as the chargeable event, at which the policyholder gets out the benefits - whether on death, maturity, surrender or assignment for money or money's worth - there is a charge to surtax on the investment gain over the amount of premiums paid. If the chargeable event is the death of the life assured, only the surrender value is taken into account, as this represents the investment element of the policy - the rest of the gain paid out is the protection profit, and it is therefore free of surtax.

Fourthly (and finally) there is what we might call a disqualified policy: This is a policy which is a qualifying policy because by its terms it satisfies the golden rule of a long term-regular payment plan, but which is subsequently not kept up for sufficiently long to satisfy the golden rule in the result. The required period for this purpose is 10 years and this period may conveniently be referred to as the quarantine period. If the policy is surrendered or assigned for money or money's worth within the quarantine period, that is a chargeable event giving rise to an immediate surtax liability. If the policy is made paid-up within the quarantine period, the policy effectively becomes disqualified, and subsequent death, maturity, surrender or assignment is a chargeable event, whether it takes place within or beyond the quarantine period. It is to be noted, however, that income tax relief obtained to date is not refundable when a policy become disqualified, showing that the disqualification provisions are aimed at negating the surtax benefits of life assurance and not at the income tax relief aspect.

A few words on the qualification requirements. The principal requirements tie up with the golden rule. To ensure that the policy is long term, it must provide for premiums to be payable for a minimum period of 10 years - the quarantine period. To ensure that the premium payments are regular in amount, the premiums payable in any one year must not exceed twice the premiums payable in any other year, with a further safeguard that, except where premiums are payable throughout life, the premiums payable in any one year must not exceed one-eighth of the total premiums payable over the whole period of the policy.

In the case of endowment assurances, there is a further requirement that the guaranteed sum assured payable on death must not be less than 75% of the total premiums payable during the full term of the policy. This helps outlaw pure endowment policies and is also no doubt intended as a - rather faint- effort to limit the tendency of some unit trust savings plans to build in a minimal amount of life cover in order to obtain tax privileges for what is in reality purely an investment programme.

Bearing in mind that term assurance do not normally have a surrender value which could give rise to a profit as compared with the premiums paid, there is a surprising amount of attention paid to them in the rules for qualifying policies, but it was presumably feared that they might become the vehicle for some ingenious forms of tax avoidance. In the case of a term assurance exceeding 10 years, the usual rule applies that the premiums must be payable for at least 10 years (or until earlier death or disability). In the case of terms of 10 years or less, the only requirement is that the policy must provide that any payment on surrender must not exceed the total premiums paid to date;

since such a policy is unlikely to have any surrender value, this is not an onerous requirement, although life offices will have to ensure that their standard policy forms are amended to include this provision.

There are a number of special qualification rules for certain special categories of policy. I would not like to go into these in detail this evening, but will mention a few of them. The first is the common case of the combination in one policy of a whole life or endowment policy plus a term assurance benefit (usually a decreasing term assurance) added as a supplement. The added term assurance benefit takes the form either of a family income provision (a series of capital sums payable from the death of the life assured during a period, until the end of that period) or of a mortgage repayment provision (a capital sum is payable in the event of death within a period which reduces according to how late in the period the death occurs, usually designed to be sufficient to repay the outstanding balance of a mortgage). In either of these cases, the policy as a whole would not meet the requirements for qualification if the reduction of premiums when the term assurance benefit falls away would result in the earlier annual premiums being more than twice the later annual premiums. These forms of combined policy are protected by paragraph 5 of the Schedule, provided both parts of the policy would by themselves qualify, the premium being apportioned between the two parts for this purpose.

Note, though, that this applies only where the term assurance benefit is a decreasing term benefit. If you have a policy incorporating, say, a whole life policy plus a level term assurance benefit (which is not uncommon) and on the term assurance benefit terminating the premium is to drop to less than one-half, the whole policy is from the start a non-qualifying policy. This is a tax-trap to avoid; which you can do by simply taking out two separate policies.

The second special category consists of contingent policies and joint life policies. Contingent policies in particular may be important in connection with the breaking of a trust, but the rules (so far as I can deduce them) are rather complex, and do not lend themselves to a verbal account, so I will rest content with referring you to the article in the "British Tax Review".

The third category is children's policies. Special rules are set out in paragraph 2 of the Schedule to deal with varying forms of children's deferred endowment assurance policies, which commonly provide that the sum assured is not payable in the event of the death of the child before a specified age. As I understand the provisions for such a policy to qualify, the maximum age it may specify for this purpose is 16, and any benefit which it provides will be payable in the event of death before that age must not exceed the amount of the total premiums paid to date. In the event of death after age 16, the usual rule for endowment policies applies, namely, that the sum assured on death must be at least 75% of the total premiums payable during the full term of the policy.

There are also two inter-related provisions relating to children's policies in paragraphs 9(2)(a) and 11(3). In order even to get to the batting crease in understanding these two further provisions, it is necessary to bear in mind the general rule that when one policy matures and another policy is issued in terms of an option contained in the old policy, there is no question of a chargeable event arising even if the old policy was a non-qualifying or disqualified policy. The new policy is treated as a continuation of the old policy. Moreover, as we shall see later, if the policy that matured was a non-qualifying, that taints the new policy, which automatically becomes a non-qualifying as well, whatever its terms.

Paragraph 9(2)(a) provides, however, that where the policy which matured secured a sum assured payable before the 26th birthday of a person who was an infant at the time of its issue and the new policy issued to that former infant satisfies the requirements for a qualifying policy, the new policy will not be tainted if the old policy was a non-qualifying policy. And paragraph 11(3) provides that the maturity of the old policy <u>is</u> a chargeable event if the old policy was a non-qualifying policy. In other words, instead of rolling the old non-qualifying policy into the new policy and thus tainting the new policy, the old policy terminates giving rise to a chargeable event, and the new policy is free of the taint.

I must admit that I can only dimly perceive the significance of these provisions dealing with children's policies, as they have clearly been designed to deal with specific plans offered by various life offices and without being familiar with those plans it is difficult to get a feel for these provisions. It would be very helpful if someone who is more familiar with such plans could give us some enlightenment during the discussion session.

The method of calculating the gain for surtax purposes is straightforward, representing the excess of the proceeds on maturity or surrender (or the consideration for the assignment) over the total premiums paid. The limitation of the gain on death to the excess of the surrender value immediately before death over the premiums paid, has been mentioned before.

Including the lump sum profit on a policy, which had accumulated over many years, in the surtax computation for the tax year in which the policy matured or was surrendered could unfairly have had the effect of bringing into the surtax bracket for that year a person whose income was normally well below surtax levels, or of imposing a high rate of surtax on a low rate surtaxpayer. Provision is therefore made for "top-slicing" relief, by dividing the profit by the number of years the policy has run and only the resulting fraction of the profit is included in his total income in calculating the rate of surtax (if any): surtax at the rate thus calculated, treating the fraction as the highest part of the income, is then payable on the whole amount of the profit.

The effect of this top-slicing relief, taken together with the fact that a policyholder can frequently choose to receive the proceeds at the time most suitable to himself from the tax standpoint, softens the impact of the surtax provisions in the case of taxpayers who do not have a high unearned income. Thus a person who pays surtax now chiefly because of a high earned income may still find it attractive to invest his relatively modest capital in a non-qualifying policy which he intends to cash in only after retirement when he is no longer a high-rate surtax-payer. At that stage he can spread any liability to surtax even further by cashing in the policy year by year over a period - or he may by then have retired to sunnier geographical and tax climes and be free of United Kingdom tax on the rest of his capital.

It will be observed that the surtax liability effectively suffered by the policyholder under a with profits policy, in respect of the investment income accumulating in the life fund, is still less severe than he would suffer if he held the investments himself, since the surtax is only payable by him on the net gain from the policy; in effect, instead of paying surtax on the grossed-up income, he pays it only on the income after the life office has paid tax. By contrast, however, he is effectively liable to surtax on the net capital gains made by the life office to the extent that they are passed on to him as bonuses.

An important practical point is that the surrender (presumably for cash) of a right to a bonus under a policy is not a chargeable event (sub-paragraph 11 (5)). Similarly, the payment of cash bonuses (which are common with Canadian companies) or of other benefits during the currency of the policy are not chargeable events. But to prevent them from escaping tax-free, the legislature has dealt with them by calling them "relevant capital payments" and making them subject to tax when the next chargeable event occurs. The reason for deferring the tax on these payments is no doubt administrative convenience, having regard to the size of the amounts that are likely to be involved and the frequency with which they could arise on a policy.

I have mentioned already that the assignment for money or money's worth of a non-qualifying or disqualified policy is a chargeable event giving rise to a charge to surtax on the gain to date. As far as the assignee is concerned, however, the surtax provisions of the Finance Act, 1968, are excluded by paragraph 11(4); any gain which he obtains on the policy is liable to capital gains tax in terms of section 28(2) of the Finance Act, 1965.

Substitutions and variations

In the various articles which have been written commenting on the provisions of the Finance Act, 1968, one of the most dreary parts has always been that dealing with substitutions and variations. This has tended to consist of a series of paragraphs reading "if the old policy was a qualifying policy or would have been a qualifying policy if it had been taken out after the 19th March 1968 and the new policy is a qualifying policy, then ..." and so on and so forth. These commentaries - and indeed the wording of the Schedule itself on this subject - have probably discouraged many of us from following through these provisions in detail, although they will in practice be of considerable importance.

I think it is possible, however, to express these provisions in the form of three simple rules, and by relating them to the reason for their enactment, to make it easy to retain them in one's mind.

The starting point is that the substitution of one policy for another is not a chargeable event, nor is the variation of a policy. In the absence of special provisions, therefore, it would have left open two types of avoidance ploys. It would have been possible to swallow the cash value of a non-qualifying or disqualified policy in a new qualifying policy, and in this way avoid paying surtax on the proceeds of a policy which did not satisfy the requirement of a long-term regular plan. It would also have been possible to graft a large additional premium payment on to an existing qualifying policy, thus conflicting with the principle of even spread of premiums. On the other hand, there are bona-fide situations in which one policy is substituted for another in circumstances where one or other of the policies does not satisfy the strict requirements for a qualifying policy or would be disqualified, and yet the two policies taken together clearly constitute a long-term regular plan - here it was desirable to relieve the policyholder from liability for surtax. These rules apply to the substitution of one policy for another or the conversion of a policy into another policy, whether on maturity of the first policy or otherwise. A variation of a policy is treated in exactly the same way as a substitution - the policy before variation is regarded as the old policy and the policy after variation as if it were a new policy substituted for the old policy. The first rule - set out in paragraph 9(2)(a) - is quite simply that you cannot cure a non-qualifying policy by substituting a qualifying policy for it, except in the case of certain children's policies. Thus, for example, if a person who has taken out a post-Budget single premium policy, the proceeds of which would be liable to surtax, converts it into a regular premium whole life or endowment policy, the proceeds of the whole life or endowment policy will likewise be liable to surtax, and he will sacrifice the income tax relief he would otherwise get on the new policy.

The other two rules deal with the situation where the existing policy is a qualifying policy and these are scrambled together in paragraph 9(2) (b) and (c). Rule 2 states what you can do after a policy has been in force for at least 10 years, while Rule 3 states what you can do before the existing policy has emerged from the 10 year quarantine period.

Rule 2 states that, after a policy has passed the quarantine period of 10 years, the policyholder can substitute any other qualifying policy for it, whether the premiums are higher or lower or the same. Moreover, he could instead substitute a policy which does not satisfy the qualification requirements as to term and spread of premiums, provided the premiums are not increased. The logic here is clear: once the policyholder has satisfied the golden rule by keeping up regular payments for at least 10 years, there is no objection to him then extending the premium-paying period, even if the period of extension is less than 10 years. But if the new policy does not itself satisfy the requirements for a qualifying policy, it is necessary to limit the amount he pays in under the new policy to the normal premium under the old policy, otherwise a person who has any policy which has been in force for 10 years could effectively take out a single premium policy by converting his existing annual premium policy and paying in a massive single premium.

A corollary to Rule 2 is provided in paragraph 8 of the Schedule. If the proceeds of a qualifying policy on maturity (or on surrender more than 10 years after its issue) are applied as a single premium or the first premium of a new policy, the new policy will not be disqualified even if it does not meet the usual requirements as to term of insurance and spread of premiums. The reason is that no additional tax savings are being sought; the proceeds, which could have been withdrawn surtax-free, merely remain in the life fund for an extended term.

Rule 3: While the policy is in the 10 year quarantine period, your freedom of movement is more restricted. You can only substitute another qualifying policy for it and there is a further proviso: the premiums payable under the new policy must not be less than one-half the premiums actually paid in any year under the old policy. The reasoning behind this rule is that, even though the old policy is in the quarantine period - so that any dealing with the policy would normally give rise to a chargeable event - the fact that you are substituting another qualifying policy means that at least 10 years' premiums will be payable under the new policy so that the golden rule of a long-term regular plan is not endangered. The proviso that the premium under the new policy must not be less than one-half the premium under the old policy is to prevent a simple avoidance ploy: but for this proviso, a man could take out, say, a 20-year endowment for a premium of £1,000 a year, and after paying the first premium, convert it into a policy under which the premiums are only £1 a year, thus effectively getting the benefit of making the policy paid-up after only one year's premiums have been paid, which is equivalent to taking out a single premium policy.

Now let us illustrate these Rules by a series of examples.

The first rule does not need further illustration: if you have taken out a post-Budget non-qualifying policy, you cannot cure it by converting it into a qualifying policy or by varying it so that it becomes a qualifying policy - indeed you will sacrifice the income tax relief and the freedom from surtax which you would have been entitled to on the new policy if you had taken it out separately.

Now let us move on to Rule 2, to look at examples of substitutions for and variations of qualifying policies which have been kept up for at least 10 years.

Where the new policy would by itself qualify as a new policy, you can do anything, whether the new premiums are higher, lower or the same - from converting a term policy into an endowment policy at one extreme to converting an endowment policy into a term policy at the other extreme. Each policy separately satisfied the requirements for advantageous tax treatment, so there is no reason why the two policies should not be joined.

Where the new policy would not by itself qualify, as regards term or size or spread of premiums, you can nevertheless graft it on, provided the premiums are not higher than under the old policy.

Thus, in the case of a 15-year with profits endowment which had already run 10 years, you could do any of the following:

(a) You could convert it into a without profits endowment policy for a reduced premium for the remainder of the 5 years

or

(b) You could convert it into a without profits policy for the same premium and the same sum assured (or even an increased sum assured) running for a longer period - say 9 years - even though the new policy would not by itself satisfy the requirements for qualification.

or

(c) You could keep it as a with profits endowment at the same premium but extend the term and increase the sum assured, once again even though the new policy would not by itself satisfy the requirements for qualification.

But in the case of a 15-year without profits endowment, or indeed a whole life or term assurance which has already run 10 years, you cannot convert it into a with profits endowment without becoming disqualified, because this would result in higher premiums than were paid under the old policy. You could do one of two things, however:

(i) You could convert it into a with profits policy for the remaining 5 year term, provided you reduced the policy so that the premiums under the varied policy did not exceed the premiums under the original policy - since these provisions are all designed to deal with life assurance as an investment and not as protection, they are not concerned with what you do to the sum assured but with what you do to the premiums.

(ii) Alternatively, if you wished to keep the sum assured the same and to pay increased premiums for the conversion to a with profits policy, you would have to extend the term at the same time, so that there were at least 10 more years to run.

Now we move on to Rule 3, to look at examples of substitutions for and variations of qualifying policies within the quarantine period of the first 10 years of a policy's life.

A convertible term policy (or indeed any term policy) can at any time be changed into any whole life or endowment policy, provided the new policy is a qualifying policy.

Similarly, a whole life policy may at any time be converted into an endowment policy, whether with profits, without profits or unit-linked, again provided the new policy is a qualifying policy.

In the converse case, there is one exception. If an endowment assurance is within the first 10 years converted into a whole life or term policy, the premium under the whole life or term policy must not be less than one-half the premium under the endowment policy. In practical terms, if a policyholder who has kept up an endowment policy for less than 10 years wants to reduce his annual premium outlay to less than half and yet wants to maintain the same life cover by means of a whole life or term policy, he has three choices:

(1) He could keep up the endowment until 10 years have passed, at which stage he can freely convert to the lower premium payment policy. If the 10 years are nearly over, this will probably be his best course. He can if he wishes borrow the premium or part of it against the policy, which he can probably do for 1 year, without losing surtax relief on the interest.

or

(2) He could make the endowment policy paid up - facing up to the fact that there will be a potential liability to surtax when a chargeable event occurs in due course - and take out a separate whole life or term policy. This has the disadvantage, if he is, or is likely to become, a high-rate surtaxpayer and the policy is likely to increase in value, that he may be building up a substantial future surtax liability.

(3) Therefore, instead of making the endowment assurance paid up, he could surrender it, thus limiting his liability to surtax. In many cases, this will be the best solution, although the surrender value may be calculated on a less generous basis than the paid up value. There will be other circumstances where he feels that his surtax rate is likely to be lower in the future than now, and of course by making the endowment assurance paid-up instead of surrendering it, the gain will potentially be spread over a long period for the purpose of calculating the rate of surtax.

If a person with an endowment policy (or indeed any other qualifying policy) wishes within the first 10 years to cut down the policy by <u>less</u> than one-half, he should not do this by making the policy partially paid-up which would disqualify the paid-up part of the policy, and hence give rise to a chargeable event when the policy becomes a claim or is surrendered or assigned. He should get the life office to do what is in economic effect the same thing but by way of substituting a new policy for the old policy or varying the whole policy, by reducing the premium and reducing the sum assured. I know we are playing with words here, but adopting the wrong procedure could result in a disqualification.

I think I have come across a major hole in the logic of 9th Schedule. If a qualifying policy has been converted into a paid-up policy during the quarantine period of the first ten years from the making of the insurance, it becomes what we have called disqualified, and subsequent death, maturity, surrender or assignment is therefore a chargeable event giving rise to a charge to surtax on any gain. But although we have for convenience chosen to say that it has become disqualified, the 9th Schedule does not say so - as far as the 9th Schedule is concerned, it remains a qualifying policy within the meaning of Part 1 of the Schedule.

Now we look at paragraph 9 (2)(b) (embodying part of our Rules 2 and 3) and find that we can substitute a new qualifying policy for old qualifying policy - there is no proviso that the old policy must not have become paid-up. In this way, the new qualifying policy swallows up the disqualified policy on which surtax would otherwise have been paid.

Thus I may take out a qualifying policy in terms of which premiums of £5,000 per annum are payable and make it paid-up after only one year. So far I have exposed myself to liability to surtax on the occurrence of a chargeable event. But I can cure this defect by waiting until the end of the 10 year period (without paying any more premiums) and then convert it into a policy to run for 10 more years at a premium of £1 per year. Effectively, I have got the benefit of taking out a single premium policy and will only have to have the patience to wait around - and stay alive - for the rest of the first 10 years. This satisfied half of the golden rule - the long-term part - but not the requirement of a regular spread of premium payments.

If I get tired of waiting before the first 10 years is up, I can still substitute a new qualifying policy during those first 10 years, but in this event, the premiums under the new policy must not be less than £500 per annum - one-half of the premium under the old policy.

Both of these alternatives are provided under paragraph 9(2)(b).

I have other difficulties with the drafting of paragraph 9(2)(b) as well, which also cut across the general logic of the 9th Schedule. The general basis is that the highest premium payable in any year under a qualifying policy must not be greater than twice the lowest premium payable in any other year under that policy. Yet returning to an earlier example of a man who takes out a 20-year endowment for a premium of £1,000 per year, we find that he could after one year convert it into a policy under which the premiums payable are £500 for the next year, and £250 thereafter. The new policy would still be a qualifying policy and the highest premium payable under it (£500) would be not less than one-half the highest premium actually paid under the old policy (£1,000), yet the policyholder will have got the benefit of putting £1,500 into the surtax-free hands of the life company in two years, with a continuing obligation only to pay £250 per year for nine more years - in other words, up to 40% of the total premiums he actually intends to pay can be got into the surtax-free fund within two years. The Revenue may wish to amend this next year - I think the word "highest" which appears twice in paragraph 9(2)(b)(ii) should have read "lowest" both times. I offer the idea to them as a sacrifice in exchange for some of the changes we hope they will make to eliminate anomalies which may be hindering the life offices.

I must admit that I am left with a nagging worry as to whether this is the correct interpretation. Paragraph 9(2)(b) is a bewilderingly difficult provision to interpret - built up of what is in effect a series of double negatives - and I have literally spent hours staring at it. Only last night I noticed a point I had not noticed before: the period of 10 years stipulated in paragraph 9(2)(b)(ii), within which the highest premium under the new policy must not be less than one-half the highest premium under the old policy, runs from the date of the <u>old</u> policy, and <u>not</u> from the date of the <u>new</u> policy.

I puzzled over this for half an hour before a highly abstruse explanation of the logic behind this struck me - so abstruse that I will not plague you with it now. I would, however, be grateful to anyone here who can enlighten me on this point.

A number of quite unexceptionable substitutions and variations are hit by these rules. For example, if I have a 15-year with profits endowment which has run eight years, I cannot without its becoming disqualified convert it into a unit-linked endowment assurance maturing at the same date even if the premium remains unaltered. It does not satisfy Rule 2 because it has not been in force for 10 years and it does not satisfy Rule 3 because it does not have sufficient years to run for the new policy to qualify on its own feet. To maintain qualified status, I would either have simultaneously to extend the term or have to keep up payments until 10 years have passed.

It would have been possible to include a provision permitting this type of substitution or variation without opening gaps for avoidance, but I should imagine that the draftsman was finding life complicated enough without trying to cater for every type of case.

The terms of paragraph 10(3)(a) provide that a variation to a policy is to be ignored if it does not affect the terms of the policy in any significant effect, whether or not it is of a purely formal character. It is not easy to draw the line as to when a variation affects the terms of a policy in any significant respect. This is presumably intended to exempt any change in the frequency of premium payment, such as arranging for premiums to be paid monthly instead of annually, even though this will involve some increase in the premiums actually payable in a period of a year. I assume, however, that the conversion of an orthodox endowment policy into a unit-linked endowment would be regared as affecting the terms in a significant respect.

A point to note is that post-Budget non-qualifying policies may be varied during 1968 for the sole purpose of converting them into qualifying policies.

For some years to come, most substitutions and variations will involve pre-Budget policies, so that it is desirable to devote particular attention to them.

As long as a pre-Budget policy is not varied in any significant respect, it is irrelevant whether it satisfies the requirements for a qualifying policy or not - the provisions of the Finance Act, 1968, do not apply to it, so that it continues to attract the income tax relief it attracted in the past, and no surtax liability can arise on death, maturity, surrender or assignment.

Nor is it relevant if the policy is made paid-up or surrendered when less than 10 years premiums have been paid.

But the Revenue clearly had to be protected against the avoidance of the new provisions which could have been effected by simply increasing the benefits secured by a pre-Budget policy or extending its term, thus in effect gaining increased benefits without meeting the requirements of a qualifying policy. This is crisply precluded by Section 16(6) which provides that an insurance made on or before the 19th March is to be treated as one made after that date if it is varied after that date so as to increase the benefits or extend the term. The policy, as varied, must then satisfy the requirements for a qualifying policy.

Thus, for example, a single premium pre-Budget policy could not, by way of variation, have additional sums assured or premiums engrafted on to it, without falling foul of the Act. Nor is it possible to extend the term of a pre-Budget policy to allow, in effect, for extra premiums and increased benefits.

The proviso to section 16(6) contains one specific exception to this provision: a pre-Budget policy may be varied during 1968 if the only effect is to increase the amount guaranteed on death to an amount equal to the minimum required for a qualifying post-Budget endowment policy of the same type. The practical reason for this seemingly unnecessary proviso is that some unit trust-owned life offices who have issued pre-Budget unit-linked policies containing low guaranteed amounts on death wish to bring them into line with post-Budget (qualifying) policies they are now issuing and hence achieve uniformity of the sum assured. But for this proviso, the pre-Budget policies in question would have been hit by the Act, if the amounts were increased.

So Section 16(6) takes care of variations of pre-Budget policies.

If, instead of varying a pre-Budget policy, you decide to substitute a new policy for it, you bring the policy within the operation of the three rules we have discussed. Thus, if a pre-Budget policy does not satisfy the requirements for a qualifying policy and you now convert it into a policy which <u>does</u> satisfy the requirements for a qualifying policy, you run into Rule 1 and the new policy does not get the benefit of qualification. This is clearly a nasty trap to avoid: you start off with a surtax-free pre-Budget policy, you convert it into another policy complying with the requirements for freedom from surtax - and you finish off with a liability for surtax which applies both to the post-conversion and the pre-conversion gains - indeed even to the pre-Budget gains.

Even if the pre-Budget policy does satisfy the requirements for a qualifying policy, you must ensure that the substitution of the new policy satisfies Rule 2 or 3, just as if the pre-Budget policy had been a post-Budget policy. Thus, for instance, if you have a pre-Budget endowment policy for a premium of £200 a year and wish after the policy has been in force for 3 or 4 years to convert it into a whole life policy for premiums of £90 a year - don't. As the old policy has not been in force for at least 10 years the converted policy will not be a qualifying policy because the premiums are less than one-half of the premiums under the old policy.

What you must do instead is to make the old policy paid-up or surrender it, and take out a separate new policy. Making the old policy paid up or surrendering it will not give rise to a surtaxable chargeable event, as untouched pre-Budget policies are exempt.

Chargeability

Now we move on to the question of the incidence of the liability to surtax. Let us start by tracing through the technical basis of the charge to surtax.

Section 16(1)(b) provides that Part II of the 9th Schedule shall have effect for the purpose of imposing charges to surtax and tax under the Finance Act, 1965, section 77. Referring to Part II of the Schedule, we see that paragraphs 11, 13 and 15 define a "chargeable event" and paragraphs 12, 14 and 16 lay down how the amount of the gain is to be computed. But the only charging provision is paragraph 17 and, as a result, if in particular circumstances there is no person on whom paragraph 17 imposes the charge to tax, then no tax is payable, even if there has been (1) a non-qualifying policy, (2) a chargeable event and (3) a gain. Unfortunately, the draftsman of paragraph 17 has ignored the rule of experience that the repeated use of the word "or" in a charging provision tends to result in grief and usually ends up in the House of Lords.

Expanding the compressed wording of paragraph 17(1)(a), we see that it imposes the charge to surtax in three cases - let us call them the three heads of paragraph 17(1)(a). The first head is that, if the rights conferred by the policy were vested in an individual as beneficial owner, the gain is surtaxable in that individual's hands.

The second head is that if the rights were held on trusts (including M.W.P.A. trusts) the gain is surtaxable in the settlor's hands. The third head is that if the rights conferred by the policy were held as security for a debt owed by an individual, the surtax liability falls on the debtor. The same three heads arise in paragraph 17(1)(b) in relation to policies vested in, settled by or held as security for the debts of, a close company, but it will be easier to follow if we stick at first to paragraph 17(1)(a) - the three heads involving an individual.

We immediately run into the ambiguities of the word "or". What happens in the common case where the policy is held on trust for the absolute benefit of the beneficiary? For example, a father takes out a policy under the M.W.P.A. for the absolute benefit of his adult son and the policy is surrendered by the trustees: does the gain fall under the first head into the son's total income as vested beneficial owner, or under the second head into the father's total income as creator of the trusts, or into both their incomes?

I think one can assume that the Courts would start off with a pretty strong assumption that the paragraph is to be interpreted in such a way as to avoid a double charge to tax, although as we shall see when dealing with other hypothetical cases, this approach could lead to some strange results.

The only reasonable way to interpret paragraph 17(1)(a) so as to avoid the double charge in the case of the father taking out a policy for the absolute benefit of the son is to read the sub-paragraph as meaning that the gain is to be included in the total income of the settlor only where the interests under the trust are not absolutely vested, and it must be conceded that this involves reading into the sub-paragraph some words which are not there. Moreover, it can be pointed out that when the legislature wanted to make similar provision in the capital gains tax legislation, imposing tax on the absolute beneficiary in the case where a trustee was a nominee or bare trustee, it did so by specific provision in section 22(5) of the Finance Act 1965.

One case which seems clear is the following. A father takes out a non-qualifying policy on the life of his son and settles the policy upon discretionary or contingent trusts for the benefit of the son and other beneficiaries. Assume the father dies first, and the son later. The death of the father is not a chargeable event and does not affect the policy in any way.

The death of the son is a chargeable event under paragraph 11, and, let us assume there is a gain under paragraph 12, but there is no-one on whom surtax can be charged under paragraph 17. None of the three heads of paragraph 17(1)(a) applies, nor does paragraph 17(1)(c), which is applicable only if, immediately before the happening of the chargeable event, the rights conferred by the policy were vested in the personal representatives of the deceased.

Now let us look at the position of a policy assigned as security for a debt. In terms of paragraph 11 (5) an assignment as security for a debt is not a chargeable event.

Take the case of a man A who owns a non-qualifying or disqualified policy on which there would be a substantial gain on death or surrender. He assigns the policy to B as security for a debt owed by B to C a third party. A then dies, creating a chargeable event and giving rise to a gain representing the excess of the surrender value immediately before the death over the premiums paid under the policy. Who is surtaxable on that gain? In terms of paragraph 17(1)(a), C - the third party debtor whose debt was secured by the assignment of the policy - is surtaxable under the third head, but can it not be argued that A is also surtaxable as the person in whom the rights conferred by the policy are vested as beneficial owner, thus falling under the first head? One's initial reaction is to say that, here again, the Court would strain against an interpretation involving a double charge to surtax and it would therefore say that the first head does not apply because, once a person has assigned his policy as security for a debt, the rights conferred by the policy are no longer vested in him as beneficial owner.

But if this interpretation - namely that the first head does not apply when a person has assigned his policy as security for a debt - is correct a wide loophole emerges. A high-rate surtax-payer finds a very low-rate tax-payer who owes some money to a third party, and, the surtaxpayer magnanimously assigns his policy to the third party as security for the debt owed by the low-rate taxpayer. On the occurrence of the chargeable event, the surtax liability falls on the low-rate surtax-payer and not on the high-rate taxpayer to whom the profit will accrue.

This can be taken one step further. The high-rate taxpayer discovers that I.C.I. (or indeed any other non-close company) always maintains an overdraft with one of the clearing banks and he goes into that bank, announces that he wishes to guarantee I.C.I.'s overdraft and assigns the policy to the bank as security for I.C.I.'s debt.

In due course he dies, and, on this interpretation of the first head, there is no-one who is liable to surtax. The only way the Revenue can get round this situation is to argue that paragraph 17(1)(a) imposes a double charge to tax and that, presumably, the Revenue may elect which person to proceed against for the tax.

An even more intriguing possibility suggests itself. A number of disgruntled insurance brokers find out that Mr. Roy Jenkins maintains an overdraft with, say, the C.W.S. Bank. They each take out a single premium Bond and assign the policy to the C.W.S. Bank as security for the debt owing Mr. Jenkins. On the face of it, it is Mr. Jenkins - and Mr. Jenkins alone - who will be liable for any resulting surtax. Perhaps that is one way of ensuring that legislation will be passed to clarify and rationalise the wording of paragraph 17(1)(a).

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