SOME ESTATE DUTY ASPECTS OF THE FINANCE ACT, 1968*

It struck me in preparing my notes for this evening that there are a relatively small number of people in this country who can be regarded as experts in the field of the interrelationship of life assurance and estate duty, and that it was likely that the majority of that select group of people would be present at the meeting this evening.

For this reason, I felt that this was a unique opportunity to put this accumulation of experience and wisdom to work for our mutual benefit by trying to stimulate as much discussion at this meeting as possible. Because the subject-matter is so broad, I have chosen to concentrate on a number of distinct topics, and it may help contain the later discussion if we all keep mainly to these topics.

I start with the assumption that we are all reasonably familiar with the changes effected by the Finance Act, 1968, and will restate them only briefly.

First, Section 37 has redefined the circumstances in which gifts forming part of the normal expenditure of the deceased will be exempt from estate duty, even if death occurs less than seven years after the gift.

Secondly, Section 35 has extended from five to seven years the statutory period for which a person has to live after making a gift in order to fall outside the estate duty net. Thirdly, Section 38 has abolished the principle of non-aggregation which formerly applied to gifts of property in which the deceased never had an interest, which were chiefly life assurance policies taken out under a Married Women's Property Act or other trust. Fourthly and finally, Section 36 now imposes limits on the amount of a gift in consideration of marriage that can be made free of estate duty.

As further background to the discussion of the selected topics, it should be borne in mind that estate duty considerations in relation to life assurance have quite different effects according to the purpose for which the life assurance is taken out, and we may distinguish at least three very different main purposes.

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*The text of an address given to the Association on 14 January, 1969, by Mr. M. A. Weinberg, B.Com., LL.M., Managing Director, Abbey Life Assurance Co.,Ltd.

First, there is the person who takes out a life assurance policy purely for the protection of his family. His object is not to avoid estate duty on part of his existing estate nor even to provide for the payment of estate duty on the rest of his estate: he may not even have an estate large enough to attract estate duty. His object is simply to ensure that there is enough money to maintain the standard of living of his family if he should die before building up a substantial estate - to replace, in effect, the income-producing capital asset which we call a man; and this is, after all, the major purpose of life assurance. If we take the case of a man aged 30 earning £2,500 a year with a wife, two small children and a mortgage, I would guess that he needs life assurance cover of at least £25,000 to make reasonably adequate protection for his family. By having most of the cover in some form of convertible term assurance, he can obtain this amount of cover for, say, £8 per month. His estate duty problem, if he gives a thought to it at all, is that the proceeds of the policy itself would produce an estate for him on which estate duty would be payable at a rate of about 12%, which means that you can either say that the amount of money left after estate duty will be 12% too little to do the job it was designed to do or, if you like, you can say that £1 of every £8 he pays each month is simply paying for estate duty on the policy itself.

Secondly, there is the person who faces up to the fact that he is going to have to pay estate duty on his death and wishes to make provision for its payment. This is a function which life assurance is admirably, indeed uniquely, qualified to fulfil since it - and it alone - can ensure that just the right amount of money is available at just the time it is needed, whether that time is the day after taking out the policy (by which time the life assured could not possibly have made adequate provision in any other way) or years and years later. Here the life assured will clearly be concerned to minimise any <u>extra</u> estate duty which he would have to pay by reason of having taken out the life assurance policy itself, because to the extent that part of the proceeds of the life assurance policy would have to be used in discharging this extra estate duty, the policy would not produce a sufficiently large amount to do the whole of the job it was originally designed to do.

Thirdly, there is the person who seeks to use a life assurance policy itself as a form of tax avoidance. The changes in estate duty law in the Finance Act, 1968, affecting life assurance were aimed at this third purpose - tax avoidance - only, although as we shall see they affected

the second purpose - life assurance to pay estate duty - to an extent as well.

Let us dispose initially of the first purpose - life assurance for straightforward family protection. On balance, I think the 1968 changes have been favourable from the point of view of the person using life assurance for family protection. In the past, there had been a choice of two main ways to minimise estate duty in these cases: the normal and reasonable expenditure exemption and the benefit of non-aggregation.

Despite the fact that the normal and reasonable expenditure provision confers total exemption whereas non-aggregation usually resulted only in a reduction in liability, the normal and reasonable expenditure exemption had never been popular with life assurance practitioners. The words "normal expenditure" had been interpreted as meaning "habitual" and Revenue practice had been that exemption was granted only when a pattern of three payments had been established, leaving a two year hiatus. There was no real guidance as to the practical effect of the requirement that the gifts had to be "reasonable having regard to the amount of the deceased's income or the circumstances". Most important of all, professional advisers were understandably nervous of the words "shown to the satisfaction of the Board of Inland Revenue". Although the view of the Revenue had been that there was a right of appeal against their decision, a judgment by the Court of Appeal in Northern Ireland had indicated that there was no such appeal and prospective policyholders were usually advised not to rely on this exemption.

By contrast, the benefit of non-aggregation was regarded as definite (certainly it was never contested by the Estate Duty Office) and once it applied there was no doubt about the measure of the duty payable - it thus allowed us all to do those long and complicated schedules showing the estate duty payable in the event of death occurring at various future dates which are such an important part of a life assurance/estate duty presentation.

I am sure that, when dealing with relatively large estates, it was indeed unwise to rely on the normal and reasonable expenditure exemption. I am equally sure that it was quite wrong to extend this caution to the tens of thousands of people taking out reasonably modest policies for family protection purposes yet as a result these people were frequently advised to create complicated trusts to prevent them having to rely on the normal and reasonable

expenditure exemption, when it ought to have been obvious that the Revenue would never contest the exemption in the particular circumstances.

The changes made by the Finance Act, 1968, in regard to the normal and reasonable expenditure exemption and non-aggregation have completely altered the balance. As regards the normal expenditure exemption, the unsatisfactory requirement of reasonableness has been deleted. In its place it must now be shown that the deceased made the gift out of his income and that, after allowing for all gifts forming part of his normal expenditure, he was still left with sufficient income to maintain his usual standard of living. Although the interpretation of this new requirement is far from clear, it is unlikely to hit at someone taking out life assurance for family protection. The new section also makes it clear that, if the Board of Inland Revenue finds against the taxpayer, there is a right of appeal. Moreover, in the debate in Parliament last year, the Minister of State announced a relaxation of the former Revenue practice that three years' payments were required. He said:

> "It is intended to relax this practice in the case of straightforward life assurance providing for regular premiums, so that even if only one or two are paid before death, the first two will be regarded as normal. This is on the ground that, by entering into a contract which envisages regular payments, the assured is, from the outset, taking on the premiums as part of his normal expenditure".

I leave it to you to judge whether this means that the exemption applies from the first, or only the second, premium payment.

At the same time, the abolition of non-aggregation has removed the prop on which most professional advisers preferred to lean. This has forced advisers to direct their attention to the normal expenditure exemption, which in its new form meets the requirements of the family protection situation better than the non-aggregation benefit ever did. Taking an unscientific guess, I would say that something like 95% of M.W.P.A. and trust policies will be exempted from estate duty by the normal expenditure exemption.

In the absence of guidance from the Revenue, it is difficult to be very definite on the interpretation of the new normal expenditure exemption. What the Revenue are plainly trying to stop is people getting "normal expenditure"

exemption when gifts are made directly or indirectly out of capital: they require it to be shown that the deceased had enough money:

(i) after paying tax and
(ii) after making normal gifts

to maintain himself out of his remaining net income. One useful formula I have seen, suggested by Mr. R. Simmons, is that the exemption applies in respect of gifts representing "income which could otherwise have been saved".

I also believe that the Revenue have accepted that, in judging whether a gift was made out of income and the deceased had sufficient income after the gift to maintain his usual standard of living, his "income" includes the capital element as well as the income element of any annuity he may take out. As a matter of law, this seems to be correct, since the whole of an annuity payment is income as a matter of general tax law, and Section 27(1) of the Finance Act, 1956, has simply deemed a statutorily-defined element to be capital "for the purposes of the provisions of the Income Tax Acts relating to tax on annuities and other annual payments".

In extreme cases, this could have surprising results. A 90-year-old has an estate worth £1 million, producing a gross income of £40,000 and a net income of about £7,000, on which he lives comfortably with something to spare. It is not much good making a gift and hoping to live seven years. He takes out an annuity for the full £1 million, producing about £300,000 per year, with the first annual annuity payment payable, say, one month after purchasing the annuity. Of this about £288,000 is the tax-free capital element and he pays tax of about £7,500 on the rest. Thus, he now has an after-tax income of about £292,000 per annum and he can make annual gifts of, say, £285,000 to his heirs and expect these to qualify for the normal expenditure exemption. I suspect that if there is to be further legislation on the normal expenditure exemption, this will be something included. Note that the example I have given has nothing to do with the case where a life policy is taken out on the life of the annuitant as an associated operation, in which case Section 37(2) excludes the normal expenditure exemption. Nor is there any need in the example quoted for the annuitant to assign the annuity to his heirs, an arrangement I shall be dealing with at greater length later in this talk.

I believe that the L.O.A. was having discussions with the E.D.O. with a view to formulating rules of guidance on the interpretation of the normal expenditure exemption and also exploring the possibility of further legislation to clarify the position, but I do not know the current state of play.

As the assuring public in this country is particularly fond of endowment policies, it is particularly important to decide on the best form of trust applicable where the man chooses to provide family protection by means of an endowment. So long as non-aggregation was the main carrot, the tendency was to advise prospective policyholders that they had to face up to forgoing any interest in the proceeds on maturity if they wanted estate duty advantages on prior death.

With non-aggregation no longer there to beguile us and the Kilpatrick decision restricting the ambit of Section 2(1)(d), an ideal solution appears on the face of it to be a trust providing that the proceeds are to be payable to the wife or other beneficiary if the husband dies before maturity, but to be payable to the husband himself if he survives to maturity. If this works it is an ideal solution because after the fourth year an increasing proportion of the proceeds would escape liability to estate duty, and indeed the normal expenditure exemption may be available, yet the life assured himself can look forward to the proceeds on maturity without worrying about being dependent on the goodwill of the beneficiary at that stage.

Here we have a perfect example of the artificiality of the present state of the law on this point and of how easy it is to go wrong in the wording of trust provisions in this area.

Some time after the Kilpatrick decision, the L.O.A. invited the E.D.O. to express its views as to how that Department interprets the effect of Kilpatrick on a number of points of interest to life offices, and someone was kind enough to let me have an extract from the resulting memorandum which I shall now quote. In doing so, I shall not refer to the hypothetical parties as A and B (which I always find confuses me considerably) but shall paraphrase it to refer to a husband and wife.

The memorandum refers first to a whole life policy effected "in trust for the wife should the wife survive the life assured husband, otherwise for the life assured husband", and the comment is "On the death of the life assured husband in the wife's lifetime, there will

be no charge to duty under Section 2(1)(d) ... The payment of premiums will not be treated as a gift with reservation of benefit and in consequence ... the claim to duty will be limited to a proportion of the sum assured corresponding to the premiums paid within five years before death" subject to the run-off provisions in respect of the third, fourth and fifth years.

It goes on to say, and I am here quoting verbatim, "The estate duty position would be the same in the case of an endowment assurance drawn for the benefit of the wife should the life assured husband predecease the wife before the date of maturity - otherwise for the life assured husband".

So this is the view expressed by the Revenue: "for the benefit of the wife should the husband predecease the wife before maturity - otherwise for the husband" does not give rise to a 2(1)(d) claim, so that duty is chargeable only under Section 34 of the Finance Act, 1959, with the, now, seven year exemption and fifth, sixth and seventh year run-off, and presumably the normal expenditure exemption.

I have had the benefit of discussing this point with leading Chancery Counsel, who has demonstrated to me very convincingly that, even within the principles laid down in Kilpatrick, on the wording in the L.O.A./E.D.O. memorandum, Section 2(1)(d) would probably apply.

This is a rather technical argument, but it is well worth relating here to get across the artificial complexity of the law and the dangers of even expert drafting. The basic point is a relatively simple one. Only if the trust wording creates an interest in possession in favour of the wife which is defeasible, does Section 2(1)(d) not apply. If, on the other hand, the trust wording creates only a contingent interest in favour of the wife, then Section 2(1)(d) does apply and the E.D.O. memorandum is wrong in relation to endowment policies.

What Kilpatrick decides is that (1) we need not worry about 2(1)(d) where the beneficiary is given an immediate prior interest in possession which is defeasible and (2) wording that looks like a contingent interest is sometimes in substance an immediate prior interest in possession, and we then in certain circumstances look to the substance not the wording - Rule in Phipps v. Ackers.

What one has to decide in each case is whether the

wife has been given an interest in possession, which is absolute but defeasible - in which event we are in the clear - or whether the husband has retained the interest in possession, giving her only a contingent interest, capable of becoming a vested interest on the defeasance of the husband's retained absolute interest, if - and only if - the event happens.

Applying this reasoning to the L.O.A./E.D.O. example on endowment policies, we see that the wife obtains the benefit of the policy if and only if the husband dies before the event (namely, the maturity of the policy) and the husband retains the interest in possession prior to the interest of the wife (namely, the right to the proceeds on maturity as well as the unencumbered right to deal with the policy if she should die before maturity). Accordingly, the better view seems to be that her interest is contingent only, Kilpatrick does not apply, and Section 2(1)(d) does. Thus, the objective of getting estate duty advantages and ensuring that the husband benefits if alive at maturity does seem capable of achievement.

In relation to whole life policies, I have been advised that the wording in the L.O.A./E.D.O. memorandum similarly fails to achieve the object, but this is a mere technicality of wording.

Leaving aside technicalities, the trust wording looks as if it creates only a contingent interest. But, as was decided in Kilpatrick, the old doctrine of the rule in Phipps v. Ackers applies in interpreting certain types of trust wording. Thus, if a trust wording states that property is to be held in trust for the wife if an event occurs but for the husband if that event does not occur, then even though that sounds like only a contingent interest in favour of the wife it will be interpreted as an interest in possession, because this interpretation avoids a vacuum of interest which might otherwise exist. But the rule in Phipps v. Ackers is a very strange rule and the courts have stressed that it will not be extended beyond its strict formulation, which was set out in the Kilpatrick decision. That formulation limits its application to the case mentioned above. If in the wording there is no gift over but a mere gift to the wife if an event happens, then the effect is that the donor retains the absolute interest and the gift would create only a contingent interest capable of becoming a vested interest in defeasance of the husband's retained absolute interest if and only if the event happens. In other words, it is the husband who retains the interest in possession.

Since we do not have the contingency of the maturity of the policy to worry about, it is relatively easy to reword the trust to give the desired effect, namely: "in trust for the wife absolutely provided that if she shall predecease the life assured husband, the policy and the proceeds thereof shall revert to and be held in trust for the life assured husband".

So much for the wording of the whole life policy. It is then important to observe the niceties of the situation very carefully indeed during the term of the policy. The important thing is to ensure that the life assured (the husband) does not in fact obtain any present benefit from the policy at any time before the death of the wife - in particular, as a result of the surrender of the policy or any loan on the security of the policy. If, for instance, a loan were made on the security of the policy, it is essential that the money thus borrowed must be held on the trusts created by the policy, and in particular must not be used for the personal benefit of the husband in any way. Thus, if the money borrowed were invested the income produced must be held or used for the benefit of the wife, not the husband, since she has the interest in possession and is entitled to the intermediate income. If the husband does not in fact get some personal benefit from the surrender or loan of the policy, before the defeasance of the wife's interest, the husband would be regarded as obtaining a benefit entrenching on the wife's prior interest, which would start the seven year gift period running afresh as regards the whole of the wife's interest in the policy.

I think all this is an excellent illustration of the Section 2(1)(d) trap. I cannot think of any word other than "trap" to describe Section 2(1)(d). Other sections can be described as charging provisions, loophole blockers or even, like Section 412 of the Income Tax Act, weapons _in terrorem_, but not Section 2(1)(d). In criticising Section 2(1)(d), I feel a little as if I were hitting a man when he is down on the ground, since Section 2(1)(d) has been so emasculated over the years by a series of court decisions culminating with the _Kilpatrick_ case that it remains only as a booby trap for the unwary.

A person who wants the policy proceeds on his death to be divided among such of his children as survive him, in equal shares, and says just that in the policy trust provisions, causes the provisions of Section 2(1)(d) to come into effect: if he rewords the provision to say precisely the same thing in a different way, namely, that

the proceeds are to be held for his children in equal shares, provided that, if one of the children predeceases him, that child's share is to be re-apportioned among the remaining children, and so on, then Section 2(1)(d) has no application. This is a section which calls out for repeal, or at least drastic curtailment and redrafting to perform whatever remaining function it may be needed to serve.

Section 38 of the Finance Act, 1968, has further restricted the ambit of Section 2(1)(d), by providing that to the extent that property passes under Section 2(1)(c) and under Section 2(1)(d), the 2(1)(c) passing generally overrides the 2(1)(d) passing.

I now move on to the second main purpose of taking out life assurance, to provide the money to pay estate duty on a person's estate, the object of the exercise here being to avoid or minimise any additional duty on the policy itself.

This is often regarded as being a problem only in regard to really large estates, but Professor Wheatcroft has drawn up a table which illustrates dramatically just how severe the estate duty liability on an additional slice of estate can be, even at comparatively modest levels. I am grateful to him for this table, which I would like to distribute.*

We are all familiar with the unfortunately named "marginal relief" - the gesture of bounty by the Revenue in terms of which the rate of estate duty within fairly wide bands is restricted to only 100%. Professor Wheatcroft's table shows that, by a combination of the effect of this marginal relief and the effect of crossing from one rate band to the next, estate duty is relatively <u>seldom</u> paid at only the table rate in respect of any additional amount in an estate.

Take a specific example to illustrate what the table shows. A man has an estate of £45,000, on which the estate duty would be £12,600. He decides to take out a policy for £5,000 for the benefit of his estate, to provide cash to pay the estate duty. This £5,000 increases his dutiable estate to £50,000, on which the estate duty is £15,500 - £2,900 more than it would have been if he had not taken out the policy. Thus, 58% of the £5,000 policy would simply go in paying the additional estate duty it caused - despite the fact that the nominal rate of estate duty at £50,000 is only 31%. Casting your eye down the column headed "Actual Rate of Duty on Excess", you will see how the rate on the additional dutiable estate runs far ahead of the nominal

* See page 25 of this Bulletin.

rate of estate duty shown in the second column in a high proportion of cases. In fact, if the man with an estate of £45,000 wanted to take out a policy sufficiently large to pay the £12,600 duty on his estate plus the extra estate duty caused by the policy itself, he would have to take out a policy for £35,000 - £12,600 to pay the original estate duty and £22,400 to pay the additional duty on the policy.

So it is clearly important to avoid or minimise estate duty on the proceeds of a policy taken out to provide for estate duty.

If the circumstances are such that the normal expenditure exemption is reasonably certain to apply, the estate-owner can simply take out a trust policy and maintain premium payments, and no estate duty liability will arise.

If the normal expenditure exemption will not apply - or it is doubtful whether it will apply - the easiest way to avoid duty is for the heirs to take out and keep up the policy on a life-of-another basis. If the heirs have sufficient money of their own to meet the premiums from their own resources, so much the better, but if they do not the life assured can make cash gifts to them to enable them to meet the premiums, and this will limit the estate duty to the amount of the cash gifted during the seven years prior to death. The normal expenditure exemption may even be available in respect of these cash gifts, but possibly the Revenue will not grant this unless at least three annual cash gifts have been made.

The only trap to avoid is that the cash must be given to the heirs and not direct to the life office, and the heirs must not be under an enforceable obligation to apply the cash in paying the premiums, for in either of these events the gift may be regarded as a gift of rights under the policy rather than a gift of cash.

A technical problem which will arise except where the life assured and heir are husband and wife is the question of insurable interest. I will spare you an attempt to make an authoritative summary of when there is and when there is not an insurable interest - these attempts are always unsatisfactory and I suspect that my attempt would have been more unsuccessful than most. The practical answer is that where it is doubtful whether there is sufficient insurable interest, the estate-owner can simply take out the policy on an own-life own-benefit basis (preferably with monthly premiums) and assign it to the heirs who make the subsequent premium payments from their own resources or

with cash gifts: alternatively, he can take out the policy on his own life in trust for the heirs and leave it to them to keep up subsequent premiums. In either event, liability on the proceeds will be restricted by Section 34 of the Finance Act, 1959, to the slice of the proceeds representing the first premium paid by the life assured, plus the amount of cash gifts (if any) made during the seven years immediately before the death, with partial relief, of course, for the gifts in the fifth, sixth and seventh years. All three of these solutions, of course, involve loss of income tax relief on the premiums, except in a husband-and-wife case.

Any reference to "life-of-another" policies seems to stir up something of an emotional reaction. I remember that at the B.I.L.A. meeting shortly after the Finance Bill was published last year, when Professor Wheatcroft, in a recorded speech, made a passing reference to life-of-another policies replacing non-aggregable trust policies, a minor storm was generated with some members expressing in very strong terms their hope that life-of-another policies would not be used to circumvent the abolition of non-aggregation.

I think it is worth analysing this view. Insofar as it relates only to combined whole life and annuity arrangements - back-to-back schemes - it is a reasonable hope and it is probably unnecessary. It seems reasonably clear that life-of-another back-to-back schemes do not work anyway and probably never have. Except where there is full medical underwriting, the taking out of the annuity clearly carries with it an implied right for the heirs to take out the whole life policy and by virtue of the "associated operations" provisions of the Finance Act, 1940, this is a disposition in favour of the relative. Section 38(2)(c) of the Finance Act, 1957, provides that where a gift is made of a right to acquire property any property acquired in pursuance of that right is dutiable in place of the gift, and this means that the policy proceeds are dutiable; the only deduction is the amount of premiums actually paid by the heirs.

But the reaction against life-of-another policies seems to go beyond back-to-back schemes. Some people base it on the sanctity of the principle of insurable interest. I personally regard the Life Assurance Act, 1774, as a somewhat absurd historical remnant. Insofar as it is still an Act of Parliament, it has to be accepted as the law, but it is not the type of law whose spirit we should be expected to respect and if anyone can get round it without actually breaching it - such as by taking out a policy and assigning it - I do not think they should have any scruples about

doing so. In particular, I think it is very wrong thinking to regard the principle of insurable interest as if it were part of the estate duty code. Insofar as its operation makes certain plans for estate duty minimisation difficult or even impossible, the Revenue are gratuitously benefiting from this historical remnant and I certainly do not think we should have any reservations about side-stepping this particular sacred cow if we can find a way to do so.

Then there are those people who think of life-of-another policies as a loophole in the estate duty code, which is certain to be closed at any early date.

I think this reasoning is equally fallacious and welcome the opportunity to analyse it. The basis of this reasoning is probably a belief that the "gift of rights" principle, introduced by Section 34 of the Finance Act, 1959, represents the fair way to charge estate duty on life assurance policies, so that the absence of estate duty on a life-of-another policy must be a loophole. The gift of rights principle, as you know, provides that, on the death of a person who had maintained a trust or assigned policy, duty is payable only on that slice, or those slices, of the proceeds represented by the premiums paid by the deceased.

The belief that the gift of rights principle is the fair one can probably be traced to two factors:

(1) First, at the time Section 34 was introduced, the industry was just recovering from the shock of the Hodge decision, in which it had been held that the proceeds of a policy on which the deceased had ceased premiums in 1916 were dutiable in full when he died in 1950. Against this background, Section 34 must have seemed the very embodiment of justice. And, of course, non-aggregation was available, so that the unfairness of Section 34 was more or less cancelled out by the unwarranted generosity of the benefit of non-aggregation.

(2) Secondly, it was said at the time, and is often still said, that Section 34 assimilated the payment of premiums on a policy to any other gift, since each slice of the policy proceeds was regarded as purchased by the premium paid. This has a superficial ring of truth about it.

The real truth, however, is that Section 34 - the gift of rights principle - discriminates severaly against life assurance. This is clearly seen by comparing the position of two men who each pay out £1,000 a year for three years for the benefit of their heirs, and then die. The first man does so by simply making a cash gift of £1,000 a year to his heirs and on his death £3,000 is charged to estate duty. The second man uses his £1,000 a year to pay premiums on a £30,000 whole life policy in trust for his heirs and, in his case, the full £30,000 is charged to estate duty - and aggregated.

Why should £30,000 be charged to estate duty in the second case, while only £3,000 was charged to estate duty in the first case? On the face of it, the justification is that the second man's heirs have received £27,000 more than the first man's heirs. The answer to this, however, is that the extra £27,000 is a life assurance benefit, not an estate duty avoidance benefit - and, in fact, is balanced out by the cases of other donors living longer than their expected life. Thus, for example, the heirs of a third man might themselves take out a £30,000 policy on his life on a life-of-another basis, wholly out of their own resources, and they, too, would make a profit of £27,000 on his death; clearly, this £27,000 is a life assurance profit - the result of his being one of the statistical exhibits who died early - and no question of estate duty would arise in the case of these heirs of the third man.

Incidentally, Parliament has recognised this point in another context in the 9th Schedule to the Finance Act, 1968. Surtax in respect of a non-qualifying or disqualified policy is only payable, in the event of death being the chargeable event, on the excess of the surrender value over the premiums paid - the rest of the sum assured is not charged to surtax as it represents a life assurance profit and not an investment profit.

Thus, I would suggest that the question is not whether the Revenue should seek to negate the duty-free nature of life-of-another contracts but whether they should take the opportunity of the promised overhaul of the estate duty laws to assimilate life policies more closely to other gifted property. With the abolition of the equally irrational but counter-balancing benefit of non-aggregation, the argument for change is a strong one. Failing this - cash gifts.

As a matter of practical politics, a Government - any Government - is unlikely simply to introduce legislation

improving the estate duty treatment of life policies, but I, for one, would be delighted to see them doing a "trade", in terms of which they, on the one hand, considerably tightened up on the opportunities for the artificial use of life assurance for avoidance of estate duty on other property and, on the other hand, loosened the gift of rights principle in respect of genuinely-used life assurance.

What, then, is the dividing line between genuine and artificial uses of life assurance? An artificial use is one where property which is dutiable in its existing form is converted in some way into a life assurance policy or combination which is immediately free of duty or dutiable only to a considerably lower extent. I think you will find on an analysis of these types of arrangements that they do not satisfy the basic principle of life assurance, namely, that there must be some people who gain financially because they are unfortunate enough to die early but, at the same time, there are a balancing number of people who live longer than their expected lifetime and thus get a relatively poor financial result (and vice versa in a genuine annuity case, those who live long gain, but this is balanced by those who die soon and lose). This is why the pre-Budget non-medical back-to-back was an artificial avoidance device: since there was no medical selection, it was a fair inference that there would be more people who could be expected to die early than those who could be expected to die later and it was this feature that made the benefit to those who died early not a life assurance but simply an estate duty benefit.

It is this element of medical underwriting that is the essential element in distinguishing between genuine life assurance and artificial tax avoidance. If the beneficiaries derive a financial benefit because the life assured died early and there was a genuine balancing chance that he could have died later, this is a life assurance benefit and not an estate duty benefit, because it is the beneficiaries of other lives assured who are living longer who are effectively paying for the benefit to the beneficiary of the life assured who dies early and not the Inland Revenue. The estate duty position of such policies should be more truly assimilated with that of any other gift.

Finally, I have been asked to comment on the efficacy of an arrangement which, I understand, has become a popular scheme to fill the vacuum left by the non-aggregable back-to-back arrangement. This example of the customary

ingenuity of the life assurance industry is what has come to be known, I am told, as the assigned capital protected temporary annuity. The estate-owner takes out a five-year temporary annuity on his own life, incorporating the not uncommon provision that if he dies before the annuity payments made amount to at least the original purchase price, an amount equal to the balance of the purchase price will be paid out by the life office. The annuity is either written in trust for the beneficiary or assigned to him and, of course, the life office pays the annuity instalments to the beneficiary for the five-year period or until the prior death of the annuitant; in the latter event, the amount equal to the balance of the purchase price is paid to the beneficiary. The overwhelming proportion of the annuity payments represent the income tax- and surtax-free capital element so that very little tax is payable.

The proponents of this scheme argue that, if the annuitant lives until the annuity payments made exceed the purchase price, no estate duty will be payable because the subject-matter of a gift has to be valued at the date of death and, at that date, the annuity contract - which is a single indivisible piece of property - has no value. If the annuitant dies before the annuity payments made exceed the purchase price, it is claimed that the duty liability is limited to the amount of the remaining payment due - and some proponents apparently try to limit this further by advising a two or three year temporary annuity instead of a five year plan.

The belief that a gifted annuity on the life of the deceased is not dutiable is one that has probably been held for a long time and appears to be an argument that the Revenue have not disputed in the past. Dymond supports this view, referring to the classic example by Lord Sands in Strathcona v. I.R.C. of the gift of a racehorse which dies before the deceased (I cannot bring myself to speak of the racehorse predeceasing the donor). Dymond's reference is a brief one:

> "Section 38(1) does not apply where the gifted property has ceased to exist and not been replaced by something else, e.g. where the gift was of a racehorse that has died or of a lease or annuity that has expired" (pages 301 and 313).

A temporary annuity is, however, different from a racehorse or a lease in one important practical respect. Before the death of the horse or the expiration of the lease, the beneficiary will, at most, have enjoyed the fruit of the tree; by the expiration of the temporary annuity, the fruit will have carried with it the totality of the tree - the beneficiary will have received in economic reality the whole capital as well as the income. Now I know that the splitting of an annuity payment into the capital and income elements by Section 27 of the Finance Act, 1956, would not help the Revenue categorise the annuity payments as part-capital, since Section 27 is a statutory definition and effective for the purposes of the Income Tax Acts only. Indeed, it may validly be pointed out that, unless an annuity was regarded under general tax law as wholly of an income nature, Section 27 would not have been necessary, but this counter-argument ignores the fact that the original liability to tax on the whole of an annuity payment was itself a creature of statute.

If there be a real argument against this new scheme, it is that the Revenue might well succeed in claiming that the subject-matter of the gift was the benefit of a contract providing for annual payments and thus, in substance, a gift of successive instalments payable during the person's life so that in terms of Section 38 of the Finance Act, 1957, the liability to estate duty would be followed through to the cash annuity payments actually received by the beneficiaries. If this argument is valid, it must apply, I concede, to a lifetime annuity as well as to a temporary annuity and the strength of one's feeling that the courts might hold against the scheme weakens when one thinks of a lifetime annuity. But, by the same token, if a five-year capital protected temporary annuity works, so presumably must a one-year capital protected temporary annuity and it would not be difficult to see a court refusing to swallow that. Certainly I do not think that the fact that the Revenue has not in the past argued that assigned lifetime annuities are dutiable gives one strong grounds for believing that they will not now challenge five-year or two-year temporary annuities, particularly capital protected annuities.

TABLE OF MARGINAL RATES OF ESTATE DUTY

Amount of Estate	Stated Rate of Duty	Actual Rate of Duty on Excess	Amount of Duty	Additional Duty in Excess over Previous Estate
£	%	%	£	£
40,000	24	45	9,600	2,250
45,000	28	60	12,600	3,000
50,000	31	58	15,500	2,900
55,000	35	75	19,250	3,750
60,000	35	35	21,000	1,750
65,000	40	100	26,000	5,000
70,000	40	40	28,000	2,000
75,000	40	40	30,000	2,000
80,000	45	100	35,000	5,000
85,000	45	65	38,250	3,250
90,000	45	45	40,500	2,250
95,000	45	45	42,750	2,250
100,000	45	45	45,000	2,250
105,000	50	100	50,000	5,000
110,000	50	100	55,000	5,000
125,000	50	50	62,500	7,500
150,000	50	50	75,000	12,500
175,000	55	85	96,250	21,250
200,000	55	55	110,000	13,750
225,000	60	100	135,000	25,000
250,000	60	60	150,000	15,000
300,000	60	60	180,000	30,000
350,000	65	95	227,500	47,500
400,000	65	65	260,000	32,500
450,000	65	65	292,500	32,500
500,000	65	65	325,000	32,500
600,000	70	95	420,000	95,000
700,000	70	70	490,000	70,000
800,000	75	85	575,000	85,000
900,000	75	100	675,000	100,000
1,000,000	75	75	750,000	75,000
1,250,000	80	100	1,000,000	250,000
over1,250,000	80	80	-	-