ICAEW REPRESENTATION 106/16
TAX REPRESENTATION

PART SURRENDERS AND PART ASSIGNMENTS OF LIFE INSURANCE POLICIES

ICAEW welcomes the opportunity to comment on the consultation paper *Part surrenders and part assignments of life insurance policies* published by HM Revenue & Customs on 20 April 2016.

This response 11 July 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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MAJOR POINTS

Key point summary

1. We welcome the government's intention to address this long-standing problem. Generally insurance companies do not appear to check with policyholders when it seems they have ticked the wrong box so amending the law seems to be the best way forward.

2. It is equitable to tax the actual gain realised over the life of the policy and not an artificial gain in one year followed by unrelievable losses in subsequent years.

3. The consultation document states that about 600 policyholders are affected annually so a complete overhaul of the system to accommodate a few appears a little heavy handed. An alternative approach not considered in the consultation document would be to retain the existing legislation other than changing the rules for deficiency relief such that the loss can be carried back to the earlier year when a gain was taxed. This has the advantage of simplicity, will not require wholesale changes by the life insurance industry and will tax the actual gain.

General comments

4. Comparing the proposals to our ten tenets in Appendix 1, options 1 and 3 fall short when considering simplicity and ease of calculation.

RESPONSES TO SPECIFIC QUESTIONS

GENERAL

Q1: Of the suggested options for change, what is your preferred option? Please explain why?

5. Of the options offered we prefer the 100% option, it is simple, results in the actual gain being taxed and does not appear to require valuations of the policy. The downside is that the gains may be bunched at the end of the policy potentially resulting in a higher rate of tax being charged.

Q2: Do you have any comments on the assessment of impacts, either generally or in relation to the specific options set out?

6. No.

Q3: Are there options beyond the three presented in this document that would better meet the desirable outcomes including ensuring that disproportionate gains could no longer arise?

7. An alternative approach not considered would be to retain the existing legislation other than changing the rules for deficiency relief such that the loss can be carried back to the earlier year when a gain was taxed. This has the advantage of simplicity, will not require wholesale changes by the life insurance industry and will tax the actual gain. There is already legislation in place to deal with a similar situation on earn outs in TCGA s279A – 279D

Q4: For each option, do the insurers' current reporting rules require amendment in any way?

8. Valuations would be required for option 1 and a cumulative total would be required for option 3. Option 2 does not appear to require much change from the present reporting system.

Q5: What costs would insurers have to incur, for each option in:
• Changes to their current IT systems to allow gains to be calculated and reported on each basis,
• Advice to policyholders on the change to the tax rules, and
• On-going costs in support of the changes.

9. We have no knowledge of what costs may be incurred by the insurers.

Q6: What possible effects would each option have on the market for life insurance products?

10. In the main the current system is simple for customers to understand if all they want to do is make an investment akin to a savings account deposit but where they have exposure to the equity market offering the potential for a greater return. If all that is required is a regular annual “income” (the 5% return) with a mopping up at the end. The alternatives in the consultation add complexity to the product and will probably deter many unsophisticated investors.

Q7: What possible extra burdens would each option place on policyholders, and how might each option affect policyholder behaviour?

11. As noted above the added complexity may deter some investors and in our view all the additional information required to report taxable events should be provided by the insurers and not require the policyholder to make the calculation of how much is taxable.

Q8: What possible tax avoidance risks does each option present, and how can these be countered?

12. There may be some inadvertent tax avoidance by non reporting of a chargeable event due to ignorance.

TAXING THE ECONOMIC GAIN

Q9: Are there any circumstances in which the A/ (A+B) formula would not give rise to an appropriate proportion of the policy’s economic gain?

13. Each calculation will result in the economic gain being taxed until a loss is made; there do not seem to be any provisions for relieving the loss so at the end of the policy too much gain may have been charged.

Q10: Is there a fairer method of calculating the part of the premium that would be deductible from the amount withdrawn when calculating the gain?

14. This approach could still result in tax being paid on a higher gain than is actually received in total at the end of the policy. Using the example in the consultation, if on final surrender the value had fallen to £50k the policyholder would have suffered an overall loss of £12k, but have paid tax on "gains" on previous withdrawals of £4,969. There is no mention of how deficiencies might be dealt with.

Q11: Policyholders would need to request a policy value in order to know what gain any part surrender or part assignment will give rise to. Are there any difficulties for policyholders and insurers in accessing this information?

15. We are unable to comment on the feasibility of the insurers producing valuations every time the policy holder part surrenders or part assigns a policy. However, if this option is adopted the onus should be on the insurers to automatically produce the valuation in the event of a part surrender or part assignment.

DEFERRAL OF EXCESSIVE GAINS

Q12: In the example provided, the pre-determined amount, above which gains are deferred is 3%. What would be the most appropriate way to set this pre-determined amount?

16. Whatever percentage is used it is artificial; the computations for this option are far too complex and will leave the policyholder uncertain of how much tax has to be paid on each surrender. When the policy has been assigned the calculations become even more complex.

Q13: Are there any circumstances in which this option would not give a reasonable result?

17. Where the policy is assigned the tax charged on each policyholder, original and assignees may not be fair.

Q14: Assignment of a policy may not crystallise all or even part of the deferred gains on that policy. What is the best way to ensure that assignees are fully aware of these deferred gains and the circumstances in which they may be crystallised?

18. We think the best way would be to require the life insurance company to issue a certificate when the policy is assigned showing the deferred gains, but the assignment may be done without informing the life insurance company.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).