# Partial surrender of life insurance policies – CIOT and LITRG's view

**Personal tax**

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The CIOT and LITRG responded to the consultation on three options for reform of the tax regime for partial surrenders or partial assignments of life insurance policies to be implemented in Finance Act 2017.

The CIOT welcomed both the formal consultation and the commitment to introducing legislation for the preferred option for change in Finance Act 2017. It follows the earlier informal consultation on proposals for change to the tax regime for partial surrenders or partial assignments to which the CIOT has contributed. The informal consultation took place against the background of a number of tribunal decisions in which the tax regime governing partial surrender of life insurance policies was subject to severe judicial criticism because of its disproportionate and inequitable effect.

The consultative options were:

1. To charge the economic gain whenever an amount in excess of 5% of the premium is withdrawn using the formula A/A+ B where A is the amount withdrawn and B is the policy value immediately after withdrawal.
2. To replace the current 5% tax-deferred allowance with a 100% allowance. Once all premiums have been withdrawn, subsequent withdrawals are taxed in full.
3. To retain the current method of taxing partial surrenders including the 5% deferral but, if the gain exceeds a pre-determined amount, say 3%, the excess would not be immediately charged to tax but carried forward to the next chargeable event.

The CIOT evaluated each option against the desirable outcomes, as set out in the consultation at 2.2 and supplemented by an additional desirable outcome suggested by the CIOT. This proposed providing a solution for taxpayers who faced disproportionate gains on partial surrender or assignment in the period up to the change in legislation.

The CIOT's view is that options 1 and 2 meet more of the desirable outcomes than option 3. In particular they are likely to be more easily understood by policyholders. For those reasons, option 3 is not the preferred option.

Option 1 spreads the liability over the life of the policy, allowing a taxpayer to better use the starting rate and savings nil rate bands. On the other hand, it is possible that policyholders might be charged to tax in relation to economic gains made in earlier years, notwithstanding that those gains are wiped out in later years with the result that the policy is loss-making overall. This is less likely to occur under option 2.

Option 2 has the advantage of simplicity and ease of understanding. However, a taxpayer may be propelled into higher rates (subject to top-slicing relief which we assume will be retained) as a result of a large gain being incurred in a single year, the premiums having been fully withdrawn earlier.

It is noteworthy that, according to the assessment of impacts, none of the options is expected to have any exchequer impact other than a negligible one. This assessment appears to be based at least in part on the figure of around 600 individual policyholders who annually make part-surrenders or part-assignments of life insurance policies in excess of the current 5% allowance. There is no attributed source in the consultation for this number of policyholders.

If option 2 is adopted, this assessment needs to be revisited because the tax position for policyholders will be more favourable than the current one, which could lead to an increase in take-up of these products.

The CIOT's Low Incomes Tax Reform Group (LITRG) also submitted a response. This was endorsed by Tax Help for Older People, which has seen cases of people with large and unexpected tax liabilities under the current method of calculating gains, focused on some particular issues for low-income, unrepresented taxpayers. Whichever solution is chosen, there is a clear need to inform policyholders of changes in the calculation of gains. Insurers will need to play a part in passing on this information, both generally (perhaps through annual valuation statements) and at the point a withdrawal or assignment is made.

Although the consultation focuses on calculation of how much of the gain is to be brought into charge, LITRG pointed out that simplification and fairness of the underlying tax rules more generally should be considered too. For example, it was unclear from the consultation – apparently aimed mostly at the insurance industry – as to whether there is an intention to review, reform or abolish top-slicing and corresponding deficiency reliefs; or to consider the interaction of taxation of income gains with the starting rate for savings and savings nil rate. With a change in calculation of gains, there is an opportunity here to consider how the rules may be made clearer and fairer for all.
Hui Ling McCarthy has written more on this subject in her article 'Life after Lobler' in the June 2016 issue of *Tax Adviser*.