HM Revenue
& Customs

Part surrenders and part assignments of life insurance policies

Summary of Responses
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1. Introduction

1.1 At Budget 2016 the government announced its intention to change the rules for taxing part surrenders and part assignments of life insurance policies (including life annuities and capital redemption policies) to ensure that disproportionate gains could no longer arise.

1.2 The current rules allow policyholders to withdraw cash from their policies (a part surrender) or sell part of it (a part assignment) without incurring an immediate tax charge. The amount which can be taken is an annual cumulative 1/20th of the amount invested, commonly referred to as the 5% tax deferred allowance. Any withdrawals within this allowance are only taxable when the policy ends, e.g. it matures or is fully surrendered.

1.3 If a part surrender or part assignment exceeds the 5% tax deferred allowance the excess gives rise to a taxable gain at the next policy anniversary. To give an example, if a policyholder invests £100,000 in a policy on 16 April 2015 and withdraws £6,000 on 17 August 2015, by way of a part surrender, then a gain of £1,000 (the excess of the withdrawal over the 5% deferred tax allowance) would arise at the next policy anniversary (i.e. 15 April 2016). This gain is chargeable to income tax.

1.4 Whilst the 5% tax deferred allowance is popular with policyholders it can, in certain circumstances, give rise to gains that are wholly disproportionate to the policy's underlying economic gain. For example, if the policyholder in the example above had withdrawn £75,000 on 17 August 2015 the gain arising on 15 April 2016 would have been £70,000. Such a gain is likely to be disproportionate to the underlying economic gain. Indeed, it would arise even if the policy was not in profit.

1.5 On 20 April 2016 the government published the consultation document "Part surrenders and part assignments of life insurance policies"[1]. This consultation ran until 13 July 2016 and sought views on a number of options for change so that disproportionate gains cannot arise from such part surrenders or part assignments. The three options presented in the document. were as follows:

- Option 1: Taxing the economic gain. Retains the 5% deferred tax allowance but brings in a proportionate fraction of any underlying economic gain whenever a part surrender or part assignment takes place.

- Option 2: The 100% allowance. Increases the 5% deferred tax allowance to 100% thereby deferring any gain until the policyholder has fully withdrawn the premium invested.

[1] https://www.gov.uk/government/consultations/part-surrenders-and-part-assignments-of-life-insurance-policies

- Option 3: Deferral of excessive gains. Defers gains above a pre-determined amount until the next part surrender or part assignment (when it could subsequently be deferred again if it exceeds the pre-determined amount).

1.6 The government received 35 contributions from industry, policy administrators, distributors, policyholder and industry representative bodies, the tax profession, independent financial advisers and individuals. As part of the response to the consultation document HMRC met with a number of interested parties for a more in-depth discussion.

1.7 Having considered the responses the government has decided not to legislate any of the three options presented in the consultation document. Instead it will accept an alternative proposal put forward by industry. This would allow the small number of policyholders who inadvertently generate a wholly disproportionate gain to apply to HMRC to have the gain recalculated on a just and reasonable basis.

1.8 Chapter 2 of this document summarises the responses received to the consultation whilst Chapter 3 sets out the government's response in more detail. A full list of respondents is included in Chapter 4.

2. Responses

General comments

2.1 Respondents universally welcomed the opportunity to respond to the consultation and help the government shape how gains from a part surrender or part assignment are to be taxed in future. All were supportive of the aim of the consultation which was to remove the risk to policyholders of disproportionate gains arising following an ill-considered part surrender or part assignment of a life insurance policy.

2.2 Many respondents preferred a targeted remedy aimed at policyholders who inadvertently generate a disproportionate gain but of the three options for change presented in the consultation document the preferred option was overwhelmingly Option 2, the 100% allowance.

2.3 Many responses, particularly those from insurers, commented that the current tax rules had been in place for over 40 years so are well established and widely understood by most policyholders and their advisers. The vast majority of these policyholders have a long-term expectation of how these products work and any widespread change may not be welcome.

2.4 Some respondents considered that industry and regulatory changes, including widespread adoption of the recent Association of British Insurers' guidance "*Cluster Policies – Good Practice for Providers*" had reduced the incidence of disproportionate gains to a handful of policyholders per year. These respondents questioned the need for wholesale changes to the current tax rules and suggested a number of possible remedies that could be applied on a case by case basis.

2.5 A summary of the responses to each question asked in the consultation document is given below.

Summary of responses to general questions asked in the consultation

Question 1

Of the suggested options for change, what is your preferred option?

2.6 Of the three options presented the preference was for Option 2, the 100% allowance. Generally respondents considered that this option was by far the easiest to explain to new and existing policyholders, the simplest in terms of the transitional arrangements required and the least costly to implement. Policyholders could easily calculate what gains would arise as, for part surrenders for example, only a record of premiums paid and amounts withdrawn would need to be kept. This option would allow policyholders flexibility in accessing cash from their policy without requiring any policy valuations.

2.7 Some respondents however suggested that this option was not fully aligned with the medium to long-term nature of life insurance policies. Furthermore, it could disadvantage some policyholders by bunching gains towards the end of the policy's life, potentially resulting in a higher overall rate of tax being chargeable.

2.8 Despite the overall positive responses to Option 2 there was a clear preference from many respondents for a more targeted solution that would avoid wholesale changes to the tax rules whilst providing an appropriate remedy for those who generated disproportionate gains (see Question 3).

2.9 A few respondents favoured Option 1 in that it would tax actual gains over the life of the policy and allow a policyholder to better utilise the Personal Savings Allowance. However it found little favour with most as policyholders would find it difficult to accurately estimate what gain would arise from any given transaction. Furthermore it was considered that for existing policyholders the transition to the new rules would be too complex, particularly for those paying regular premiums or making regular withdrawals. It would also require costly and complex changes to insurers' IT systems.

2.10 Option 3 found little favour with respondents. Most considered this option to be extremely difficult for policyholders to understand and unsatisfactory in that it limits rather than prevents disproportionate gains. Many thought that the administrative burden that this option would place on policyholders would be too substantial.

2.11 A number of respondents had no preferred option. They considered that many existing policyholders would struggle to adapt to any new tax regime for these products.

Question 2

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

2.12 Some insurers considered that the number of individuals making part surrenders and part assignments was higher than the 600 quoted in the consultation document. Nevertheless respondents considered that most of these gains would be small, generating little if any taxation. The number of individuals whose actions now give rise to disproportionate gains was considered to be, at most, only a handful a year.

2.13 A number of respondents considered that whilst policyholders tend to have above average income, they also tend to be older and more vulnerable. It was stressed by many that any changes to the taxation of these policies had to be easily understandable and provide no or little additional administrative burden for policyholders.

2.14 In respect of the impact on businesses some respondents commented that all options would require costly changes to insurers' systems. For some insurers, few or no new policies are now being written. Any additional costs will therefore be unwelcome especially as these disproportionate gains now arise to only a very small number of policyholders.

2.15 Some respondents were concerned that all of the options presented would be difficult to deliver by early 2017.

Question 3

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

2.16 Many respondents expressed the view that the current basis of taxation was clear and that the vast majority of policyholders and their advisers fully understand the implications of a part surrender or part assignment and the options available to them. Market and industry changes had greatly reduced the number of policyholders making ill-informed decisions and generating disproportionate gains to just a handful a year.

2.17 With this in mind many respondents suggested that wholesale changes to the tax rules for part surrenders and part assignments were not an appropriate or proportionate response. They were concerned that the product expectations of the many would be materially altered to address an issue arising for a tiny minority. Alternative options were advanced which included allowing policyholders who had mistakenly generated disproportionate gains a period of time to provide alternative instructions to their insurers or for HMRC to allow disproportionate gains to be recalculated on a different basis for tax purposes.

2.18 Respondents stated that this alternative would ensure that the vast majority of policyholders would be completely unaffected by these changes. As such they and their advisers would not have to understand a new tax regime for their policies or how any transition would work. Insurers argued that this would dispense with the need to make costly changes to their IT systems. It would however provide a remedy for the handful of policyholders who are subject to these disproportionate gains.

2.19 Some respondents also suggested changes to deficiency relief such that it could be carried back and set against any earlier gains whilst others suggested abandoning the concept of a part surrender or part assignment in favour of only bringing gains into charge on policy termination.

Question 4

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

2.20 Respondents considered that the current reporting rules would not require amendment for any of the three options proposed. It was noted by some respondents that all options were likely to result in reduced reporting obligations to HMRC as there would be fewer reportable gains.

2.21 Some respondents suggested that insurers would want to provide additional information (such as the deferred gain in Option 3) so as to assist their policyholders to comply with their tax obligations. Without this many considered that policyholders would struggle to calculate their gain correctly.

2.22 A number of respondents suggested that Option 2 could allow further simplification of the rules by using the end of the tax year instead of the policy anniversary as the point at which gains from part surrenders or part assignments arise.

Question 5

What costs would insurers have to incur for each option?

2.23 Insurers advised that any change would require amendments to their product literature, changes to IT systems and processes, additional staff training, education and support for policyholders and advisers and the develop of new self-help tools. In the absence of operational detail for each option, insurers were not able to estimate the exact costs for each option with a high level of accuracy. Insurers considered that all options would be expensive to implement but most insurers considered that changes would be most costly for Options 1 and 3.

2.24 A number of respondents commented that IT departments are currently under major strain with a number of changes already required for current regulatory and tax changes.

2.25 Overall cost estimates per entity ranged from around £200,000 to £1,500,000 depending upon the number of policyholders and the nature and age of their legacy IT systems. Some respondents considered that this work would be difficult to finalise for an April 2017 implementation.

Question 6

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

2.26 Most insurers advised that the market for insurance products in the United Kingdom has been in decline in recent years. The majority considered that none of the options presented would reverse this trend, indeed it was likely that Options 1 and 3 would add so much complexity that these products would become significantly less attractive.

2.27 A small number of respondents thought that Option 2 could marginally increase the size of the market as its simplicity would make life insurance policies a more attractive investment.

2.28 Some respondents raised concerns that implementing each option would burden insurers with large additional costs. Even if only a small fraction of these costs were passed onto policyholders this could be viewed as unfair as the vast majority would be paying for a change that is beneficial to only a few.

Question 7

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

2.29 Option 1 was generally seen by respondents as being complex and difficult to understand with policyholders being unable to calculate the gain arising from a part surrender or part assignment without help from their insurer. Some suggested that policyholders would respond by not taking part surrenders in excess of 5%.

2.30 Option 2 was generally seen as simple and easy to understand. Policyholders would be able to easily calculate their tax deferred allowance and resulting gains. Of the three options this placed the smallest additional burdens on policyholders and their advisers.

2.31 Option 3 was widely considered to be the most difficult for policyholders to understand whilst imposing the greatest administrative burden in requiring deferred gains to be tracked by policyholders over a number of years.

2.32 A number of respondents commented that all options could result in increased costs for policyholders as they may need to pay for professional advice to understand the new tax rules (and particularly for Options 1 and 3 when contemplating part surrenders and part assignments). It was likely that any change would lead to more policyholder enquiries for insurers and HMRC.

Question 8

What possible tax avoidance risks does each option present and how could these be countered?

2.33 Generally no significant additional tax avoidance risks were identified especially as the deferral of gains was already a feature of the current tax rules.

2.34 Some respondents considered that the General Anti-Abuse Rule in Part 5 of Finance Act 2013 would provide a sufficient safeguard against tax avoidance using these policies.

2.35 One respondent considered that Option 3 could be so complex that policyholders would struggle to calculate and declare the correct gain arising from a part surrender or part assignment.

Summary of responses to specific questions asked in the consultation

Option 1: Taxing the economic gain

Question 9

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?

2.36 Most respondents accepted that the A/(A+B) formula would give rise to an appropriate gain but policyholders would no longer be able to easily calculate the gain arising from a part surrender or part assignment. Furthermore it was considered that there would be a difficult and complex transition for existing policyholders.

2.37 Some respondents commented that whilst an appropriate gain may arise at the time of the part surrender or part assignment nevertheless if the value of the policy subsequently decreased (and deficiency relief was not fully usable) over the life of a policy an excess of gains could still be taxed.

Question 10

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

2.38 Most respondents did not suggest a fairer method although some made suggestions for differing methods of calculating the available premium and in particular how the 5% deferred tax allowance could be applied.

2.39 Other respondents considered that the removal of the 5% allowance from the calculation would give the fairest result, albeit this would eliminate the 5% deferred tax allowance which most policyholders were comfortable with. Some respondents suggested a single calculation on each policy anniversary. Whilst this would not always give a completely accurate gain calculation it could simplify matters by reducing the number of calculations involved.

Question 11

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?

2.40 Respondents commented whilst most of this information was readily available to policyholders it was not always possible to obtain a daily valuation for some assets, e.g. where policies are linked to suspended funds, or where an investment manager is only obliged to provide quarterly data. In such situations this could cause significant difficulties if policyholders required an immediate valuation to estimate what gains would arise from a particular part surrender or part assignment.

2.41 Some respondents also advised that even though valuations would be readily available for most assets, in periods of price volatility the value of a policy could change markedly between the point of requesting a valuation and the actual surrender or assignment being implemented.

2.42 The request for a valuation could give rise to disputes between the policyholder and the insurer as to the valuation the insurer gives for the policy (e.g. should it reflect market value adjustments etc.). Additionally a small pricing error in any given valuation could compound that error across a large number of subsequent gain calculations.

2.43 Some respondents stated that the number of valuations requested from insurers would most likely rise considerably. This would put an additional burden on insurers and there may be some pressure to make a charge for this service.

Option 3: Deferral of excessive gains

Question 12

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?

2.44 A number of respondents suggested that as 3% was an arbitrary figure, for simplicity purposes using 5% may be the most viable option.

2.45 Some respondents recommended that whatever the pre-determined amount, it should be changed as infrequently as possible so as to avoid further complexity.

Question 13

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

2.46 Many respondents commented that the gains arising under this option could still be viewed as disproportionate if the actual returns on the underlying investments were less than the pre-determined amount.

2.47 Some respondents noted that this option would not allow a policyholder to bring gains into charge above the pre-determined amount. This would negate an important feature of these policies for some policyholders who want to spread taxable gains over a number of years so as to lower their overall tax liability.

2.48 It was noted that if the ownership of a policy is assigned the new owner could become liable to tax on deferred gains arising from the previous owner’s actions.

Question 14

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?

2.49 Many respondents commented that in such circumstances it should be the responsibility of the assignor to inform the assignee of the uncrystallised deferred gains. Insurers are unlikely to be able to address this proactively as they are often advised only after the assignment has taken place.

2.50 HMRC should also provide clear guidance as to what policyholders and advisers need to do when policies are assigned with uncrystallised gains. Comments were also submitted that this would make assignments in these circumstances particularly onerous for policyholders.

2.51 Some respondents suggested an alternative approach might be to crystallise deferred gains following an assignment.

3. Next Steps

3.1 The government thanks everyone who responded to this consultation and especially the overwhelmingly positive response to its intention to change the tax rules for part surrenders and part assignments of life insurance policies. The detailed and constructive responses have proven useful when considering the nature of the actual changes required.

3.2 In view of the representations made by interested parties the government will not legislate any of the options outlined in the consultation document. It is acknowledged that recently improved policyholder support and education provided by industry and financial advisors has reduced the number of disproportionate gains to just a handful a year. Consequently the government considers that a change to the tax rules for all policyholders is no longer appropriate. Whilst each option addresses disproportionate gains in the hands of the investor they also generate a disproportionate cost for policyholders and industry in adjusting to new tax rules.

3.3 However, the government remains committed to providing a remedy for the handful of policyholders who unintentionally generate disproportionate gains when making a part surrender or part assignment of their life insurance policy. The government sees merit in the alternative proposal put forward by some respondents, suggesting that policyholders with disproportionate gains might apply to HMRC for their gains to be recalculated on a just and reasonable basis. This suggestion would deliver the policy aim of removing disproportionate gains whilst avoiding a change to the tax rules for the vast majority of policyholders and will not generate disproportionate costs for industry.

3.4 Revised legislation for this remedy will be published, for further comment, following Autumn Statement 2016. It will form part of the Finance Bill 2017 and will come into effect from 6 April 2017. Detailed guidance will be published prior to the remedy coming into effect.

3.5 The government will closely monitor the effect of this change.

Annexe A: List of stakeholders consulted

Association of British Insurers
Aegon Ireland plc
Aegon UK
Association of Financial Mutuals
Association of International Life Offices
Armstrong Watson
Aviva
Barclays Bank plc
BDO LLP
Canada Life Ltd
Capita plc
Chartered Institute of Taxation
Deloitte LLP
The Institute of Chartered Accountants in England and Wales
IntegraLife International Ltd
International Financial Data Services
Investment and Life Assurance Group
KPMG LLP
Legal & General Group
Low Incomes Tax Reform Group
Liverpool Victoria
Manx Insurance Association
Mark Dean Wealth Management (UK) Ltd
Old Mutual
Prudential Assurance Company Ltd
PWC LLP
RL360 Insurance Company Ltd
St. James's Place plc
Standard Life plc
Technical Connection Ltd
Tilney Bestinvest
Weslyan Assurance Society

Three individuals