making qualified comparisons

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Colin Jelley explains the taxation considerations required to enable fair comparisons of protection products for inheritance tax planning.

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Financial advisers have always demonstrated versatility and the ability to adapt as markets evolve. The Skandia Financial Planning Index in last month's informer demonstrated how advisers are successfully adapting business models – and in the current climate advisers are also successfully reviewing the type of business written.

In rising investment markets, protection business can sometimes appear to be the poor relation in the advice sector. But as we have seen before, the protection arena can come to the fore and offer excellent opportunities as market conditions become more challenging. A financial health check may well highlight protection requirements such as business assurance and personal cover. Clients may have left these unchanged, ignoring changes in personal circumstances. Many clients will still have unprotected inheritance tax (IHT) bills and may not be in a position to reduce the liability by gifting capital assets.

wide choice

The choice of using protection for IHT planning has increased in recent years. The unit-linked whole of life plan (WOL) still offers excellent value but for those also looking to eliminate the investment risk, the guaranteed WOL market is now well established.

The guaranteed premium approach was developed in response to demand from financial advisers, with the benefit of avoiding future premium reviews being particularly attractive to the older client. This is especially true when market conditions may effect the underlying fund growth. Premiums, however, may appear more expensive under guaranteed products than under unit-linked – but as we know there are always factors to consider other than just the initial price.

Some unit-linked whole life products are also offered by offshore life companies, with the benefit of assumed gross investment roll up reflected in a lower premium than its UK counterpart. Where a product is provided by an offshore provider it will, by default, be a non-qualifying contract (see table), as will some UK unit-linked contracts. But does this matter? Let's consider the issues.

tax considerations

Offshore companies assume 'gross' growth rates to support their products, as (broadly) they do not pay tax on the investment return within the life fund. This enables them to be very competitive on a 'standard cover basis'. The key difference from a client perspective is that a non-qualifying (UK or offshore) contract may have a potential income tax liability on death if all of the underlying assumptions are met.

The sum assured from all products is paid 'tax free', but on the death of the last surviving life assured a taxable gain may arise. An income tax liability will arise if the surrender value at date of death exceeds the premiums paid – the difference is the gain and will be liable to income tax. Where the policy is an offshore non-qualifying policy, the tax will be levied at the individual's highest rate. A non-qualifying policy offered by a UK insurer will have already suffered life fund taxation and would only give rise to a liability of 20% where the policyholder was a higher rate tax payer. However, where the policy is qualifying, no tax is due.

Targeting the protection market will certainly provide excellent opportunities for both personal and corporate clients. However, differentiation of cover and how the plan is priced and taxed may far outweigh selecting the cheapest premium.

The example on the facing page clearly sets out the taxation issues relating to qualifying and non-qualifying WOL policies.

IHT planning using protection products

	UK unit-linked WOL	Offshore or UK unit-linked WOL	Guaranteed WOL
Tax status	Qualifying	Non qualifying	Non qualifying or qualifying
Surrender value	Yes	Yes	No
Tax liability	No	Yes	No

example calculation

qualifying and non-qualifying policies

- **Male 65 next birthday/Female 64 next birthday**
- both non smokers
- sum assured £700,000 and are higher rate tax payers
- Joint life last survivor basis.

UK unit-linked WOL (QUAL) quote*
– **£1046.84 pm**

Offshore unit-linked WOL quote*
– **£1037.90 pm**

Guaranteed WOL quote*
– **£1082.20 pm**

*Source for UK unit-linked WOL quote: The Skandia Plan. Source for Offshore unit-linked WOL quote: The Exchange. Source for Guaranteed WOL quote: Skandia GWOL. All quotes obtained on 9 February 2009.

Let's assume the last of the lives assured dies at a time when the surrender value is equal to the sum assured or close to it (a normal assumption for standard cover). Then on the last death all three product types would pay the sum assured of £700,000 'free of tax'. Under the Skandia guaranteed WOL there is no surrender value available – so no additional tax to pay on death. While the qualifying contract has a surrender value greater than the premiums paid, its qualifying status means there would be no further income tax liability (ie no additional 20% charge).

However, for the offshore non-qualifying contract where the surrender value is expected to be greater than the premiums paid, there would be a potential 40% tax charge on the difference:

Premiums paid: £1037.90 x 12mths x 35years = £435,918

Assumed surrender value = £700,000

£700,000 - £435,918 = £264,082 x 40% = £105,632

The executors of the deceased's estate would have to pay an income tax bill of £105,632. You will draw your own conclusions on which solution best meets the needs of your client.

This article is based on Skandia's interpretation of the law and HM Revenue & Customs practice as at 30 January 2009. We believe this interpretation to be correct but cannot guarantee it.

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