PRUDENTIAL

Counsel's opinion on the Prudence Inheritance Bond

Bare Trust Version

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Prudence Inheritance Bond Bare Trust Option

This document sets out the Counsel's Instructions submitted to the QC and the Counsel's opinion subsequently received.

Inheritance Tax

General gift with reservation provisions

Q. Is it Counsel's opinion that the endowment and whole of life policies are two separate policies and that the retention of the endowment policy can be viewed entirely separately from the gift into trust of the whole of life policy.

Is HMRC likely to regard the endowment policy and the whole of life policy as not two policies but one? This is on the basis that Prudential would not issue either of them individually on the terms offered. If one regards the investment as one composite policy, could it be successfully argued that the retention of the endowment policy is an effective carve-out of rights retained by the investor/ donor?

So, even if there was only one policy, does Counsel agree that provided that there were clearly defined rights within the policies and that there was a proper retention of rights by the donor (ie. to the endowment policy) and giving away of other rights (ie. to the whole of life policy), it would not appear to matter for inheritance tax purposes if HMRC argued there was merely one policy.

Counsel's attention is also drawn to the legal constitution of the funds. It is understood that, in effect, the investment assets that would normally comprise one fund have been broken down into two funds – one providing returns linked to capital value and one enjoying the income from those capital assets. It is of course possible to separate an entitlement to income and capital in property by use of a trust. It is also possible to notionally earmark income within a unit-linked fund by allocating special units in respect of those income distributions which are held within the same policy and owned by the same policyholder. It is not so easy to see how one unit-linked fund can be entitled to the income of another but Prudential has achieved this with this Bond.

However, in light of this the question then arises as to whether the investor (donor) has truly divested himself of all the benefits of the whole of life policy when he makes a gift of that policy. In effect the gift of the whole of life policy to the bare trust involves a gift of the Capital Fund supporting that policy and, by definition, the endowment policy which is kept by the investor would have no value without the existence of the Capital Fund because no income would be generated.

Does Counsel feel that the associated operations provisions could apply here to link the gift of the whole of life policy, which invests in Capital Fund units, and the payment of income from the Capital Fund into the Income Fund that supports the endowment policy that is retained by the investor, and if so, can Counsel confirm what the consequences would be and how this could be avoided.

A. In my opinion the endowment and whole of life policies, if they take the form indicated in my Instructions (I have not seen copies of the policies themselves), will be treated as two separate policies for the purpose of inheritance tax, and the retention of the endowment policy, which entitles the Investor to income, will not be regarded as a reservation out of the whole life policy for the purposes of s.102 Finance Act 1986.

At first sight it looks, both from my Instructions and from the literature explaining the working of the Prudence Inheritance Bond, as if the investments which produce the income are held on trusts under which the Investor retains the income and the capital is held for the discretionary beneficiaries. If this were the case, I should have no doubt that the Investor's right to income would be a benefit reserved to him out of the gift.

Further consideration shows that this is not the way in which the Bond works. As I understand it (and I assume that this is made clear in the terms of the policies), there is no trust relationship of this kind. The Bond gives the holder purely contractual

rights, and the "underlying investments", as they are termed, in which the Investor's money is notionally or actually invested are held by the Company for its own benefit, the terms of the Company's contract with the Investor being in essence that it will pay to the holder of the endowment policy a sum equal to the income payable on the investments each quarter or each month, and will pay to the holder of the whole life policy, on the death of the Investor, a sum equal to the value of the investments at that time. The holder of the endowment policy will be the trustees of the endowment policy, who will hold the quarterly or monthly payments which they receive from the Company on trust for the Investor and will normally pay them out to him as they are received – indeed it is possible for the quarterly or monthly payments to be made direct from the Company to the Investor in the instructions of the Trustees, as is commonly the case where dividends of trust investments are mandated to the life tenant of a settlement.

The holders of the whole life policy will similarly be the Trustees of the whole life policy, and on the death of the Investor they will deal with the payment they receive from the Company in accordance with the trusts on which the policy is held, which in the case of the Bare Trust Bond are for one or more beneficiaries absolutely. As a matter of law, the nature of the trusts on which the two policies are held is of no concern to the Company, whose only obligations are contractual obligations to the Trustees. The position will, in fact, be analogous to that which exists in a simple split capital investment trust which issues income shares, carrying a right to the whole of the income of the investments held by the investment trust (with or without a right to repayment of the value of the shares at par), and capital shares, carrying the right to the whole of the capital (less the value of the income shares at par if the company's articles so provide), usually on a defined date on which the investment trust is terminated. There can in my opinion be no doubt that a donor can make a gift of the capital shares of such a split capital investment trust and retain the income shares without there being any question of his retention of the income shares being treated as a reservation out of his gift of the capital shares, because the investments held by the investment company are not subject to any trust of which the company is a trustee (despite the company being called an investment trust), the rights of the holders of income and capital shares being purely contractual and dependent on the articles of the investment company. Similarly, in my opinion, the Investor in the Prudence Inheritance Bond makes an outright gift of the whole life policy, and the fact that he retains the benefit of the endowment policy does not lead to the conclusion that such retention is a reservation of a benefit out of the gift of the whole life policy.

The Prudence Inheritance Bond possesses two features which make the scheme appear more complex than it really is. First, the underlying investments held by the Company are treated as divided into two funds. One fund, the Capital Fund, supports the Company's obligation under the whole of life policy to pay a sum equal to the full value of the underlying investments on the death of the Investor. The assets representing the whole of life policy, which is held by the Trustees for the beneficiaries other than the Investor, are notionally divided into Capital Units. All capital growth accrues to the Capital Fund, and the Investor has no direct interest in it. The other fund, the Income Fund, is the recipient of sums equal to the whole of the income produced by the underlying investments. The Income Fund is similarly notionally divided into Income Units, which constitute the assets held by the Trustees of the endowment fund on a bare trust for the Investor, and sums equal to the income of he underlying investments are paid out to the Investor, or otherwise dealt with at his direction, at quarterly or other agreed intervals during his life (or until he reaches the age of 105 if he so long lives). The Revenue currently accept that payments equal to no more than 5% of the premium paid for the policy under which the endowment fund is brought into existence are free of income tax until a total equal to the premium has been received by the Investor. If the Investor receives more than 5% of the original premium in any year, or more than 100% of it in total, he may be subject to higher rate tax on the excess. If he receives sums equal to less than the income produced by the Income Units, he may redirect the excess into another fund or funds managed by the Company, and the Revenue currently accept that if he does so and does

not receive the excess himself he will not be treated as having received them for the purposes of higher rate tax.

The second feature, on which depends the maximum amount which the Investor can receive free of tax under the 5% allowance, concerns the allocation of the overall premium which the Investor pays for the Bond. It appears that the Revenue currently accept that the allocation of the premium between the whole of life policy and the endowment policy is a matter for agreement between the Company and the Investor, and need bear no relation to the comparative values of the two policies. The scheme therefore provides for 99% of the amount available for investment (which may differ by a modest amount from the premium actually paid by the Investor) to be allocated to the endowment policy, and the remaining 1% to the whole of life policy. This enables the Investor to be paid under the endowment policy 5% per annum of 99% of the amount available for investment free of tax.

The Scheme is thus in essence simple, though there are some additional features which appear to me to make it look more complicated than it really is, and to justify the statement in Part C of my Instructions that "the underlying structure is relatively complex".

Taking the specific questions in this part of section D of my Instructions, my answers therefore are as follows:

- In my opinion there are no grounds on which HMRC can properly regard the endowment policy and the whole of life policy as one policy rather than two for inheritance tax purposes. Although Prudential would not issue either of them individually, the two are in law quite distinct, and in my opinion they clearly satisfy the test stated by Lord Hoffmann in Ingram V IRC, [2000] I AC 293 at p.305:

  "What, then, is the policy of section 102? It requires people to define precisely the interests which they are giving away and the interests, if any, which they are retaining. Once they have given away an interest they may not receive back any benefits from that interest. In Lang v Webb, 13 C.L.R. 503, 513 Isaacs J. suggested that the policy was to avoid the "delay, expense and uncertainty" of requiring the revenue to investigate whether a gift was genuine or pretended. It laid down a rule that if the donor continued to derive any benefit from the property in which an interest had been given, it would be treated as a pretended gift unless the benefit could be shown to be referable to a specific proprietary interest which he had retained. This is probably the most plausible explanation and accepting this as the policy, I think there can be no doubt that the interest retained by Lady Ingram was a proprietary interest defined with the necessary precision".

  The two policies are in my opinion clearly "defined with the necessary precision", and the Investor derives no benefit whatever from the whole of life policy.

- Even if HMRC were to argue that there was merely one policy, because of the link between the two, this would not in my opinion matter for inheritance tax purposes. There are many schemes in the market which involve only one policy, such as the discounted gift trust schemes, where the rights retained by the donor (such as the right to periodic withdrawals under the policy) are sufficiently clearly defined not to amount to a reservation out of the property that is given; and HMRC have for many years recognised that if they, or the trusts on which they are held, are properly drafted there is no gift with reservation.

- I agree that it is possible to notionally earmark income within a unit-linked fund by allocating special units in respect of those income distributions which are held within the same policy and owned by the same policyholder: it is not really the case that one unit-linked fund is entitled to the actual income produced by another, since the obligation to the policyholder is contractual and he has no proprietary interest in either the capital or the income of the investments held by the Company, however they are described. It would be possible, for example, for the endowment policy to provide for the Company to pay out a sum equal to each distribution of income which is received as it was received, and there would still be only

a contractual right vested in the policyholder, but administratively it is clearly simpler to provide in effect for quarterly or monthly payments of sums equal to the income received during the quarter or month.

- I think the suggestion that a question arises as to whether the Investor has divested himself of the benefits of the whole of life policy, because the gift of the whole of life policy to the Trustees involves a gift of the Capital Fund supporting that policy and the endowment policy would have no value but for the existence of the Capital Fund, involves the kind of category error referred as above. The Investor and the Trustees of the whole of life policy have no beneficial interest in the Capital Fund. Its performance measures the amount of the payment to be made under the whole of life policy when it matures, but the Trustees do not have an equitable interest in the investments underlying the Capital Fund as a result-their rights remain purely contractual. It is similarly irrelevant that the rights of the trustees of the endowment policy are measured by the amount of income produced by the Capital Fund: their rights too are purely contractual, and the income of the underlying investments is in no sense held in trust for them.
- In my opinion the associated operations provisions have no application here. There is no relevant association between the effecting of the two policies; and, as mentioned above, it would not matter if there was, since the question for inheritance tax purposes is not whether the two policies, or the Capital Fund units and the Income Fund, are associated, but whether the rights retained by the Investor are clearly defined and constitute property that is not given, rather than the reservation of a benefit out of property which is given. The answer to that question is that they are.

Paragraph 7 Schedule 20 Finance Act 1986.

Q. This is a specific anti-avoidance provision aimed at lump sum inheritance tax plans which Counsel will be familiar with.

The only connection between the two policies in terms of policy benefits arises in respect of the bid value of the units in the Capital Fund. At the maturity date of the endowment, part of the maturity proceeds represents a sum which is equal to the then value of the units in the Capital Fund, which does of course underpin the whole of life policy. However, it is understood that this payment will be a payment made under the terms of the endowment policy and will not involve encashment of the units in the Capital Fund which will continue in force following the investor's 105th birthday. This means that the payment of the maturity proceeds will not affect the whole of life benefits payable on the life assured's death which in turn means that Prudential therefore takes a commercial risk on the life assured not attaining age 105 as otherwise two payments will effectively have to be made.

If one accepts that the Capital Fund and the Income Fund are truly distinct funds, as there is no linking in levels of benefit payment between the whole of life policy and the endowment policy, para 7 Schedule 20 would not, therefore, appear to be a problem unless it could be said that the "capital" value of the Capital Fund influences the "income" value of the Income Fund.

Does Counsel feel that the benefits under the whole of life policy vary by reference to the benefits that accrue under the endowment policy and does he think this specific piece of anti-avoidance legislation applies to the Prudence Inheritance Bond? Please can he give reasons for his views.

A. I agree that the benefits under the whole of life policy do not vary by reference to the benefits that accrue under the endowment policy; and that accordingly paragraph 7 Schedule 20 Finance Act 1986 has no application. The value of the Capital Fund is no way dependent on the amount of income which accrues

in the Income Fund. The relation between the two is, again, analogous to the relation between the capital and income shares of a simple split capital investment trust.

Back to back arrangement – Section 263 IHT Act 1984

Q. The impact of the back to back provisions is that where an annuity is purchased and a life policy is placed in trust and the life policy is not issued on the basis of full medical evidence, the transaction can amount to a chargeable transfer based on the purchase price of the annuity and the first premium paid under the policy or the greatest possible benefit that can be conferred under the life policy. The question here would therefore be whether the endowment policy could, in reality, be regarded as an annuity (perhaps on the basis that the distribution payments available to the investor originate from income that arises on capital held in a fund underlying a whole of life policy and for the benefit of another person). If this is the case, the back to back associated operations rules could apply.

It may well be considered that the endowment policy has the feel of an annuity in that the investor can receive a regular flow of income and yet on his death before maturity date only a nominal payment will be made (ignoring the value of any redirected or undrawn funds).

On the other hand there are characteristics of the endowment policy which distinguish it from an annuity policy – for example income is not necessarily paid to the investor – it can be paid into a separate investment account under the reinvestment option. Also it must be borne in mind that the endowment policy has a maturity value which of course is not a normal feature of an annuity policy.

No statutory definition is given of annuity but it has been described judicially as "when an income is purchased with a sum of money and the capital has gone and has ceased to exist, the principal having been converted into an annuity." In the case of the Prudence Inheritance Bond, it seems doubtful that the capital has gone and so this definition would not directly cover the situation. It is known that the Inland Revenue's previous attempt to tax the settlor's rights to income under a capital redemption plan, known as the PELF, as an annuity failed in the Special Commissioner's decision of Sugden – v – Kent.

Can Counsel confirm that in his view the endowment policy with the Prudence Inheritance Bond is not in fact an annuity.

A. In my opinion s.263 Inheritance Tax Act 1984 has no application either. One of the conditions which have to be satisfied in order that s.263 may apply is that "an annuity on the life of the insured is purchased": s.263(1)(b). As Arden LJ said in IRC v John Lewis Properties Ltd, [2003] Ch.513, 538, the purchase of an annuity means "the exchange of a lump sum for the instalments of an annuity". Cf the definition of "purchased life annuity" in s.423 Income Tax (Trading and Other Income) Act 2005. Here the endowment policy is not in my view comparable to an annuity, (a) because the quarterly amounts payable under it vary with the variation of the income derived from the underlying investments in a way which is quite different from the payments of instalments of an annuity, and (b) because, as is pointed out in my Instructions, the endowment policy does not simply cease to exist on the death of the Investor but has a maturity value on the happening of that event, albeit not a very large one. Moreover in my opinion it cannot properly be said that there is an exchange of the lump sum which is paid for the whole of life policy for the income which is payable under the endowment policy: the former retains its full value on the death of the Investor after payments under the latter have come to an end.

Artificiality of the arrangement

Q. Two aspects need to be considered in relation to the possible artificiality of the arrangement; firstly the impact of the allocation of the premiums and, secondly, whether the Plan could, in reality, be regarded as only one policy. The "one policy" issue was dealt with in (i) above and is not considered further here.

Does Counsel feel it would be possible for HMRC to challenge the allocation of premiums between the endowment policy and the whole of life policy and, if so, what would be the impact of a positive challenge?

It would seem that on the basis that the premium allocation was arbitrary and not based on actuarial principles such a challenge could be made. However, one needs to consider what advantages HMRC would gain by adopting this attitude.

For inheritance tax purposes the true cost of each policy to the investor is only relevant as regards determining the discounted gift element which is achieved on an actuarial basis. Therefore, provided that certain policy rights have been correctly given away and other policy rights retained by the donor, then HMRC has nothing to gain from an inheritance tax standpoint by challenging the allocation of premiums under the Plan.

Of course, there may be an income tax advantage in HMRC challenging the allocation of premiums as if the endowment policy had a lower premium, then this would affect the calculation of the 5% withdrawal level (see below).

A. I agree that it is immaterial whether the two policies are regarded as one: see above. As to the allocation of the premiums, this depends on the agreement between the Company and the Investor and is not decisive on the question of the value transferred by the gift of the whole of life policy, and in fact the 99% of the premium allocated to the endowment policy and the 1% allocated to the whole of life policy are obviously not realistic, whatever the age of the Investor. The true value of the endowment policy is the value of the rights to income during the life of the Investor, and this is what will be discounted from the total amount paid by the Investor in order to determine the value transferred by his gift of the whole of life policy, and this depends on actuarial calculations and not on the allocation of the payment between the two premiums: see (v) below.

Value transferred

Q. Confirmation that:

- the transfer of value for inheritance tax purposes at outset would be the value of the (full investment) by the Donor less the present value of his rights under the endowment policy retained which is determined by actuarial assessment of the present value of the future income during the Donor's life arising on the Capital Units purchased by the initial investment.
- all of this discounted transfer of value (to the extent that it is not exempt) would be a potentially exempt transfer.

A. I confirm that:

- The value transferred by the Investor will be the diminution in value of his estate resulting from the transaction viewed as a whole: s.3(1). This will be ascertained by deducting from the total amount paid by the Investor (the aggregate of the two premiums) the value of his rights under the trusts of the endowment policy, which will itself be determined by actuarial calculation.
- The discounted transfer of value will be a potentially exempt transfer, subject to any available exemptions.

Undrawn income

Q. Confirmation that the value of any undrawn income in the form of income units would form part of the investor's taxable estate on death.

A. I confirm that the value of any income which is undrawn or income units which remain uncashed under the endowment policy will form part of the Investor's taxable estate on his death, since the policy is held in trust for the Investor absolutely.

Value of Investor's rights

Q. Confirmation of the factors that Counsel feels should be taken into account in determining the present value of the Donor's right to the endowment policy. In particular, we know that HMRC Inheritance Tax has expressed the view that in calculating the market value of the Donor's rights under discounted gift trusts one uses the willing vendor/ willing purchaser principle and if the Donor is not in good health this would take account of the cost of life assurance cover needed to secure the purchaser's investment. Is this view correct in relation to the Prudence Inheritance Bond?

A. I confirm that the value of the Investor's rights under the endowment policy will be their market value: s.160; and this will be ascertained on the willing vendor/willing purchaser basis. If the Investor is in poor health the willing purchaser might be expected to pay less and the market value would therefore be less. By how much it would be less would be a matter for negotiation with HMRC; but the cost of life assurance cover to meet the possibility of the Investor's early death, and thus secure the willing purchaser's notional investment, would provide a guide to the adjustment that might be negotiated to the market value which the policy would have if the Investor was in normal good health. If insurance cover is unobtainable, the value will be treated under HMRC's practice as nominal: see HMRC's Technical Note issued on 2 May 2007.

Joint Investors

I confirm that

a. **Q.** In a joint Donor case the present value of each Donor's interest in the endowment policy interest would need to be valued separately for IHT purposes (but see (c) below).

A. Where there are joint Investors, the present value of each Investor's beneficial interest in the endowment policy will need to be valued separately for IHT purposes. HMRC's practice with regard to valuation in the case of joint Investors is set out in its Technical Note referred to above.

b. **Q.** In a joint Donor case (where the Donors are married or are registered civil partners), part of the discounted gift at outset (that part treated as supporting the surviving Donor's entitlement after the first Donor's death) would be dealt with in accordance with HMRC's recent statement on how discounted gifts should be apportioned on joint Donor cases involving a husband and wife.

A. Where there are joint Investors who are married or are registered civil partners, part of the discount will be attributable to the fact that after the death of the first to die the payments under the endowment policy are made wholly to the survivor. This will be taken into account in the separate valuations of the interests of the two Investors.

c. **Q.** That even though full payments will continue to the surviving Donor after the first death, there will be no transfer of value from the deceased Donor at that time because the possibility of this event will have been taken into account as part of the discount at outset (see (b) above) and, in any event, on the death of the first Donor to die, any interest that then passes to the surviving Donor is not property to which he or his estate is entitled to. The effect of, say, the husband dying first is to mean that an increased amount becomes payable to his wife. The husband did not own that right, nor did he have an interest in possession.

A. There is therefore no transfer of value on the death of the first to die. His or her right to half the payments made under the endowment policy simply comes to an end, there is no property to which his estate is entitled, and there is no passing of property to the survivor: the survivor simply becomes entitled to the full amount of the payments under the endowment policy as a term of the trust on which the policy is held.

d. Q. Confirmation whether the answer to any of the points above would be affected by section 119 Finance Act 2002 ("Settlement Power").

A. In my opinion s.119 Finance Act 2002 (settlement power) has no application in this situation and no effect on my advice on any of the above points.

Bare Trusts

Q. Confirmation is required that the trust will be treated as a bare trust and not a discretionary trust

A. I confirm that the trust of the endowment policy will be treated as a bare trust, even though a change of entitlement occurs on the death of the first to die of two joint Investors. The change is inherent in the nature of joint beneficial ownership.

The trust of the whole of life policy will also be treated as a bare trust, if the form of Absolute Trust (Form 2) is adopted.

POAT

Q. Please can Counsel confirm that the trust wording means that no resulting trust would arise on the Donor which could invoke the POAT provisions.

A. I confirm that there will be no possibility of a resulting trust to the Investor; and the pre-owned assets provisions in Schedule 15 Finance Act 2004 will have no application.

Income Tax

Part Surrenders and Current Chargeable Event Legislation

Surrender value of whole of life policy

Q. Whilst technically it might be possible for the trustees to request a surrender of both the whole of life policy and the endowment policy if both were in their ownership, it is understood that Prudential will not agree to such a surrender on the grounds that this would prejudice one of the conditions of the policies that the policies cannot be surrendered. This, in turn, could lead to chargeable event problems on the payment of the death benefits under the whole of life policy.

Currently, the whole of life policy has no surrender value and so, despite it being a non-qualifying policy, no income tax liability will arise when the sum assured is paid on death. If the plan was regarded as just one policy, on payment of the proceeds under the whole of life policy, although no surrender value exists, all previous part withdrawals would need to be taken into account – these would be relevant capital payments for higher rate tax purposes.

A. I agree that, if it is correct that the whole of life policy has no surrender value, despite its being a non-qualifying policy no income tax liability should arise when the sum assured is paid on death. However, even if the Company would not permit surrender, it seems to me that the policy must have a value immediately before the death, and that this should be regarded as its surrender value for income tax purposes. I agree that, if the two policies are regarded as one for income tax purposes, previous payments under the endowment policy will be taken into account as relevant capital payments for the purposes of s.541 Income and Corporate Taxes Act 1988.

5% Part Surrender Base

Q. Alternatively, if HMRC decided to allocate "true premiums" to each of the components in the plan, (bearing in mind that, at present, the policies do not stand up individually) the premium allocated to the endowment would be reduced which would mean that the available 5% withdrawal figure would also be reduced. This means that higher rate income tax could arise on part surrenders that had been based on 5% of 99% of the initial purchase price of the whole Bond (ie. the premium allocated to the endowment policy).

Please could counsel give his views on whether the consequences stated in (i) or (ii) above are likely to result. If the risk of either is significant what could be done to minimise the risks?

A. Again, if the two policies are regarded as one for income tax purposes, it would in my opinion follow that the two premiums should be aggregated and the 5% tax free element of the payments made under the endowment policy calculated on the total amount of the premiums paid on both policies, not merely on the 99% of the aggregate premium which is allocated to the endowment policy. The excess over 5% will be liable to income tax if it is withdrawn by the Investor, as is recognised in paragraph 19.2 of the Product Specification accompanying my Instructions and in Section 4 of the Adviser's Guide "A Creative Approach to Inheritance Tax Planning".

I do not consider that there are any steps which could usefully be taken to minimise the risk of HMRC claiming tax on the above bases.

It will be borne in mind that the definition of "settlement" for income tax purposes(e.g.s.670 ICTA 1988) is wider than its definition for inheritance tax purposes (s.43 IHTA 1984). Although they do not at present do so, as I understand it, HMRC could possibly take the view that the mischief at which the 5% tax free limit on withdrawals is aimed is breached if the Investor takes more than 5% of the part of the premium which would be allocated to the endowment policy on actuarial assumptions, despite the fact that the payments under the endowment policy are not framed so as to constitute withdrawals, and claim tax accordingly. I do not see any way of avoiding this without redesigning the whole Scheme; and, as mentioned above, the Product Specification accepts that tax is payable on the excess over 5% of the amount allocated by agreement to the endowment policy. However, in the normal type of discounted gift scheme, of course, the withdrawals to which the donor retains the right are normally limited to 5% of the whole premium, so that the Investor in the Bond is in fact entitled to a little less than under a more normal discounted gift scheme, so that I do not think HMRC could reasonably view the Bond as a whole as a means of mitigating income tax; and if withdrawals of a greater amount are permitted by the policy, there is no doubt that income tax is payable on the excess. If the excess of payments under the endowment policy over 5% is left in the policy, as the scheme permits, it should not be subject to income tax.

Nature of Investor's Rights

Q. Please can Counsel confirm that in his view that the payments to the investor from the endowment policy would not be treated as savings and investment income under ITTOIA 2005 (previously Schedule D Case III income). If Counsel takes the view that they could be so treated, please can he confirm that no income tax would arise because of the relief afforded by section 504 ITTOIA 2005 (previously section 79 Finance Act 1997) so that they will only be subject to the life policy chargeable event rules.

A. I confirm that in my view the payments under the endowment policy should not be treated as savings and investment income under ITTOIA 2005; but if there were any doubt on the point, no income tax would be payable on them: ITTOIA s.504(6).

Pre-owned asset provisions

Q. The pre-owned asset provisions have been introduced in Schedule 15 Finance Act 2004.

Confirmation is required that because in the case of the Prudence Inheritance Bond the Donor disposes of intangible property to a trust of a whole of life policy under which the trust fund is held on a bare trust for others (and from which the Donor but not his spouse is excluded from benefit), an income tax charge under Schedule 15 Finance Act 2004 will not arise. Please can Counsel confirm that this is the case even though the investor enjoys a benefit by virtue of owning the endowment policy, the value of the Income Units of which reflect the income arising on the Capital Units which attach to the whole of life policy.

A. I confirm that in my opinion no income tax charge will arise under Schedule 15 Finance Act 2004. This is so, in my opinion, notwithstanding the fact that the Investor retains an entitlement to payments under the endowment policy. It is not the case that the Income Units necessarily reflect the value of the Capital Units with any degree of accuracy: the Investor is entitled to the benefit of the endowment policy under a separate contract with the Company. The Revenue confirmed, in a letter to the Association of British Insurers which was published in Taxation magazine for 18 November 2004, that the pre-owned asset provisions do not apply to the more normal case of a single policy held on trusts under which the donor retains certain benefits but the remaining benefits enure for others. In my opinion the Prudence Inheritance Bond is analogous to such a case, and the distinction between the benefits retained by the Investor and those which enure for the benefit of others is even clearer than in the more normal case with which the Revenue's letter to the ABI is concerned.

General

Q. Currently there is no choice of investment funds underlying the Capital Fund and consequently the investment fund underlying the Capital Fund cannot be changed.

Does Counsel feel that any adverse inheritance tax or income tax implications would arise:

a. If such a choice of funds existed-which could affect the amount of the yield to the income fund which supports the Donor's retained rights

b. If the Donor or Trustees had the right –after the Plan was effected-to change the underlying fund and thus influence the level of the payments to the Income Fund and thus the amounts received by the Donor.

A. I do not consider that there would be any adverse tax consequences if the underlying investments by reference to which the extent of the Company's contractual obligations under the two policies is calculated were capable of being changed during the currency of the policies. This is a common feature of many unit-linked policies.

It is true that such a change would influence the level of the payments made to the Investor under the endowment policy, but I do not consider that it could be said that the benefits which accrue to the donee "vary with reference to benefits accruing to the donor" within the meaning of Sch.20 para. 7(1) Finance Act 1986: see paragraph (1)(ii) above.

S.538 ITTOIA

Q. Can Counsel consider what the tax effect would be of the Donor not exercising his power to recover tax from the trustees under section 538 ITTOIA. If this would amount to a transfer of value, could this be avoided by the trust excluding the Donor's power to recover the tax and, if so, would this be advisable?

A. If the Investor becomes liable for tax under ITTOIA in respect of the whole of life policy and he foregoes his right to recover the tax under s.538, this would in my opinion amount to a transfer of value to the

beneficiary or beneficiaries entitled under the whole of life policy. It would be possible to avoid this if the original Declaration of Trust contained a provision waiving the right; but this would be unusual, and it is not easy to see circumstances in which the Investor could be assessed to tax in respect of the whole of life policy. There would, of course, be no purpose in including such a provision in the Declaration of Trust relating the endowment policy, since the benefit of that policy is held in trust for the Investor absolutely. If the Investor were to deal with the benefits to which he is entitled under the endowment policy in a manner which amounted to a transfer of value, the right to recovery under s.538 could be dealt with at the same time.

Trusteeship

Q. Please can Counsel confirm that no adverse tax implications will arise because of the Donor being able, subject to certain conditions, to remove trustees.

A. I confirm that no adverse tax consequences will arise by reason of the Investor's right to remove trustees. It is a condition of the exercise of the power, under clause 6 of the Declaration of Trust, that there shall remain at least one Trustee other than the investor, so that there will be no possibility of the Investor having sole control of the policy.

Generally

Q. Please can Counsel advise generally on any relevant tax or legal issues arising out of the use of this Trust.

A. I do not think there are any other relevant tax or legal issues not considered above.

Wilberforce Chambers,
Lincoln's Inn
7 March 2008

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