Transaction-related calculations

Overview

Under the chargeable event rules, an assignment which is not for money or money's worth will not trigger a chargeable event. In other words, an assignment by way of gift does not create a chargeable event.

Accordingly, if bond is assigned by way of gift and a chargeable event gain subsequently arises, then typically that gain will be assessed against the individual who owns the bond at the time. But, not always.

Consider the situation where there has been part surrender or part assignment for money or money's worth. In that case, a 'periodic calculation' is required at the end of an 'insurance year' to establish if a gain has arisen.

Part surrenders are very common but part assignments much less so. In this article we will therefore focus only on part surrenders and ignore part assignments for money or money's worth.

With the above caveat in mind, if the periodic calculation shows a gain arising at the end of the insurance year, due to a part surrender (or surrenders) exceeding 5% limits, and certain conditions are satisfied, then a calculation is required in respect of each part surrender in the order they occurred. The conditions to be satisfied are

- During the insurance year there has been a part surrender followed by either a part or complete assignment by way of gift.

Special rules apply where the insurance year in question is the final insurance year.

With that in mind, this article explores, and provides examples of the following scenarios.

I. In a particular insurance year there has been a part surrender followed by a part or complete assignment by way of gift. Accordingly, a 'transaction- related computation' is required for each part surrender in the insurance year in the order in which they incurred.

II. In the final insurance year there has been a part surrender followed by a part or complete assignment by way of gift. If so, a transaction-related computation is again required in respect of each part surrender, and this is to be performed separately from and before the standard chargeable event calculation occurring on the final event.

The object of these rules is to impose the income tax charge on the person who benefitted from the surrender rather than the person who held the rights at the end of the insurance year.

The relevant legislation is contained in Sections 510 to 514 ITTOIA 2005.

Key points

- Where there has been part surrender, then a ‘periodic calculation’ (the ‘5% rule’) is required at the end of the ‘insurance year’ to determine if a gain has arisen. If so, it is chargeable to income tax for the tax year in which the insurance year ends.
- Special rules apply where there has been a part surrender exceeding 5% limits followed by a part or complete gifted assignment. If so, a further ‘transaction-related’ calculation is required for each part surrender in the insurance year in the order they occurred.
- If additionally, the insurance year is the ‘final’ insurance year then further complications arise as discussed below.
- The transaction-related calculation ensures that each part surrender is treated as a chargeable event in its own right, taking place when it occurs rather than at the end of the insurance year. The gain is however still charged by reference to that insurance year end.

Definitions

‘Insurance year’ - An insurance year runs from one anniversary date to the day prior to the next anniversary date. For example, a policy taken out on 1 June has an insurance year running 1 June to 31 May each year. This is sometimes called a ‘policy year’.

‘Final insurance year’ - If an event brings a policy or contract to an end - full surrender, death giving rise to benefits, or maturity - the insurance year is treated as ended on that date. It is then referred to as the final insurance year.

If that rule would result in an insurance year beginning and ending within the same tax year, then the ‘final insurance year’ is extended to include the previous ‘insurance year’.

Example of an extended final insurance year

Assume there is an ‘insurance year’ running from 1 June 20X4 to 31 May 20X5 and the policy is fully surrendered on 30 June 20X5. That would give rise to a year beginning on 1 June 20X5 and ending on 30 June 20X5. Given that both of these dates fall in the same tax year, then the previous insurance year and the shortened year are taken together as the single final insurance year.

Accordingly, the ‘final insurance year’ will run from 1 June 20X4 to 30 June 20X5.

‘Periodic calculation’ - Where there is a part-surrender, then a periodic calculation is required at the end of the insurance year in which the event occurs to determine whether a chargeable gain has arisen and, if so, its amount. Essentially, the calculation is to determine whether part surrenders have exceeded the cumulative 5% allowance. This is known as the ‘5% rule’.

‘Transaction-based calculation rule’ - This applies where a calculation under the 5% rule above shows a gain, but within the same insurance year there has been a part surrender followed by a gifted part or complete assignment. The rule is designed to ensure that the gain is charged on the correct person – the assignor – not the person otherwise liable as owner at the end of the insurance year.

'Part surrender event' – where a transaction based calculation is carried out (see above), then each such part surrender is treated as a chargeable event in its own right and referred to as a part surrender event. Each takes place when it happens rather than at the end of the insurance year, although the gain is still charged by reference to that year. These part surrenders are recognised in the order they take place, with a special rule in the final insurance year.

The 'transaction based calculation' rule

As outlined above, if the cumulative 5% allowance is exceeded so that there is a gain at the end of the insurance year, but within that insurance year there has been a part surrender followed by a gifted assignment, then the transaction-based calculation rule applies.

What are the consequences of the rule applying?

- No gain will be treated as occurring at the end of the insurance year. Instead, a calculation is performed for each part surrender during the insurance year to determine whether a gain has arisen and, if so, its amount. Each part surrender is assessed against the accumulated 5% allowance.
- If a gain has arisen then the relevant part surrender will be treated as a chargeable event called a part surrender event.
- If more than one part surrender occurs during an insurance year, the calculation is performed for each in turn, recognised in the order they take place.

Therefore, each part surrender is treated as a chargeable event in its own right, and this part surrender event takes place when it happens rather than at the end of the insurance year, although the gain is still charged by reference to that year.

The owner at the point the tax deferred allowance is exceeded is assessed on the resulting excess gain(s).

Why is it that the date on which a part surrender event arises is the date of the part surrender and not the date on which the insurance year ends?

Because this ensures that the gain is attributed to the person liable at the time of the event, rather than the person liable at the end of the insurance year.

Note the comment above that gain is charged for the tax year in which the insurance year ends (despite the fact that the chargeable event is not treated as occurring at the end of the insurance year!).

As explained below, there is a special rule in the final insurance year.

The 'transaction based calculation' rule – and a final insurance year

Where the year in question is the final insurance year, then

- The transaction based calculation is performed before the calculation of any gain on the chargeable event which ends the final insurance year (i.e. full surrender, death or maturity).
- Special rules apply where the total transaction value exceeds the 'gains limit'

The total transaction value = the part surrender in question plus any part surrenders occurring earlier in the final insurance year.

The gains limit = the gain which would have arisen on the chargeable event which ends the final insurance year, if the transaction-related calculation rules did not apply.

In a final insurance year scenario, the related chargeable event is treated as occurring before the chargeable event that ends the insurance year.

Example – part surrender then a gifted assignment in an insurance year

Alan invests £100,000 in a bond on 10 June 20X0. The position is then as follows.

Insurance Year	5% allowance	Part surrenders / Assignment by way of gift
10 June 20X0 to 9 June 20X1	£5,000	N/A
10 June 20X1 to 9 June 20X2	£5.000	N/A
10 June 20X2 to 9 June 20X3	£5,000	N/A
10 June 20X3 to 9 June 20X4	£5,000	N/A
10 June 20X4 to 9 June 20X5	£5,000	Part surrender - 15 Aug 20X4 £20,000 Part surrender - 13 Nov 20X4 £25,000 Gifted assignment - 10 Feb 20X5 into joint ownership by Alan and wife Beth Part surrender - 6 April 20X5 £10,000

All transactions occur in the 5th insurance year. Cumulative 5%s at the end of the insurance year 5 are £25,000. The total part surrenders of £55,000 exceed this figure. Within the same insurance year, there has been a part surrender followed by a gifted assignment and therefore the transaction based calculation rule applies.

We need to perform a calculation for each part surrender as follows.

15 Aug 20X4

- The £20,000 part surrender is fully covered by the cumulative allowance of £25,000 and therefore no gain arises. There is a £5,000 carry forward to the next part surrender.

13 Nov 20X4

- The £25,000 part surrender exceeds the £5,000 brought forward from the part surrender on 15 August by £20,000. Therefore a part surrender event of £20,000 occurs on 13 Nov 20X4 which falls in insurance year ended 9 June 20X5. Alan is taxable on this in tax year 20X5/20X6.

10 Feb 20X5

- Assignment by way of gift with no chargeable event arising.

6 April 20X5

- The £10,000 part surrender will all comprise a gain since the 5% allowance has already been fully used. A part surrender event occurs on 6 April 20X5 which falls in insurance year ended 9 June 20X5. Alan and Beth are equally taxed on this in tax year 20X5 to 20X6.

Part surrender then a gifted assignment in a final insurance year

Clara invests £100,000 on 24 June 20X4. The position is then as follows.

Insurance year	5% allowance	Part surrender/Assignment by way of gift/Full surrender
24 June 20X4 to 23 June 20X5	£5,000	£5,000 (1 July 20X4)
24 June 20X5 to 23 June 20X6	£5,000	£5,000 (1 July 20X5)
24 June 20X6 to 23 June 20X7	£5,000	£5,000 (1 July 20X6)
24 June 20X7 to 23 June 20X8	£5,000	£5,000 (1 July 20X7)
24 June 20X8 to 27 Aug 20X8		Part surrender – 1 July 20X8 £5,000 Gifted assignment – 20 Aug 20X8 into single ownership of husband Dan Full surrender by Dan – 27 August 20X8 - £90,000

If Clara had not made part surrenders, then Dan would simply be liable for the final chargeable event gain of £15,000 (see below). Instead, there have been both withdrawals and a gifted assignment in the final policy year, so a transaction related calculation needs to be carried out.

Note that an insurance year began on 24 June 20X8 and ended on 27 August 20X8 which means that both occur in the same tax year (20X8/20X9). Accordingly, the previous insurance year and the shortened year are taken together as the single final insurance year.

The 'final insurance year' will therefore run from 24 June 20X7 to 27 August 20X8.

There is therefore only one 5% tax deferred allowance to set against withdrawals during that time.

The next step is to find out the 'gains limit' (i.e. the gain which would have arisen on the chargeable event which ends the final insurance year, if the transaction-related calculation rules did not apply). This is as follows.

	£
Surrender value	90,000
Part surrenders	25,000
Previous gains	N/A
Premium paid	(100,000)
Gains limit	**15,000**

We now need to carry out the calculation for the transactions in the final year. This ensures that the excess gain will never be higher that the final gain of £15,000 calculated above.

In the final insurance year from 24 June 20X7 to 27 August 20X8 there are two part surrenders of £5,000 each on 1 July 20X7 and 1 July 20X8.

The first part surrender is within the accumulated 5% allowance; therefore no chargeable gain arises on this.

The second part surrender exceeds the accumulated 5% allowance by £5,000 so there is an excess chargeable event gain of £5,000. The withdrawal exceeded the 5% allowance while the bond was owned by Clara, and therefore she will be assessable.

The bond was then gifted to Dan so no chargeable event arises on that.

The gains in the final insurance year are now recalculated to determine who is liable.

	£	Who is assessable?
Surrender value	90,000	
Part surrenders	25,000	
Premium paid	(100,000)	
Previous gain	(5,000)	Clara
Final gain	**10,000**	Dan

Note that the part surrender gain does not get swept up with the gain on full surrender as would be the case if there had been no assignment involved.

If Dan had waited until the new tax year i.e. after 5 April 20X9 to surrender the bond, he would have been liable for the full gain.