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Cluster Policies – Good Practice for Providers

Why is this statement needed?

1. Many insurers offer policyholders the ability to split an investment, (typically an investment into a single premium investment bond), equally between a number of identical life insurance policies or 'segments'. These are commonly known as cluster policies. A policyholder who wishes to withdraw a sum of money from a cluster policy may do so by either a full or part surrender of policies within the cluster or a combination of the two methods. However, depending on the chosen method, and the circumstances of the policyholder, the tax consequences can be very different in each case and, once a withdrawal has been validly completed, the tax consequences cannot be reversed.

2. There have been a number of cases, some of which have been discussed in the Courts[1], where policyholders have been faced with significant tax bills, which could have been avoided had they withdrawn their money differently. The purpose of this statement is to suggest to providers how they can help policyholders avoid making a choice which leads to an unnecessary tax bill.

Tax Consequences

3. The precise tax consequences will depend on an individual policyholder's circumstances. The rest of this document assumes that the taxable person is an individual and UK resident for income tax purposes.

4. The relevant tax rules are very technical and can result in a tax charge even if no economic profit is made. They seek to tax 'gains' made, and the formula used to calculate the gain depends on whether a policy/segment is surrendered in full or in part.

5. The reason for the bond being divided up into a cluster of policies is flexibility. If a policyholder wants a specific sum from their investment they could either:
   - fully surrender some of the individual policies within the bond, or
   - part surrender all the policies within the bond, or
   - adopt a combination of these two methods

6. However, the method chosen can significantly affect the tax calculation. If they fully surrender one or more individual policies/segments, then they will pay income tax at their marginal rate (less an amount equivalent to basic rate tax if appropriate) on any gain the individual policies have made. In contrast, if they make a partial withdrawal from one or more policies without making a full surrender, they will be charged to tax on the full amount of money withdrawn less an allowance of 5% of the premium paid for each year since the payment of the premium. Although this method of calculation is a simplification measure which avoids the need for

[1] For example: Joost Lobler v Revenue & Customs [2013] UKFTT 141 (TC)

complex arithmetic on a partial withdrawal, it can give rise to a chargeable gain which is wholly artificial and bears no relation to the actual growth (if any) that has accrued within the policy.

Example 1

George took out an investment bond for £50,000 in March 2011. The bond was issued as a series of 100 identical segments of £500 each. For the sake of simplicity assume no growth and no charges.

In February 2013, George requested a partial withdrawal of £40,000. If this were fulfilled by taking a partial withdrawal across all the segments this would create a chargeable gain of £35,000 (£40,000 less the cumulative 5% allowance (2 years X 5% X £50,000=£5,000) giving a gain of £35,000). Assuming George were a higher rate taxpayer, this would result in an income tax liability of £7,000 (40% X £35,000 less basic rate credit if appropriate of 20% X £35,000).

However, if the withdrawal were fulfilled by the full encashment of 80 of the segments, no chargeable gain would have arisen as there would be no gain, and there would therefore be no income tax liability.

Example 2

Mildred took out an investment bond for £100,000 in March 2003. The bond was issued as a series of 1,000 identical segments of £100 each. (For simplicity assume that there are no charges).

In February 2013, when the bond had risen in value to £125,000, Mildred requested a partial withdrawal of £50,000.

If this request were fulfilled by a part withdrawal across all segments then the chargeable gain would be £0. (i.e. £50,000 less 10 years of 5% allowances of £50 for each of the 1000 segments). So there would be no income tax liability.

However, if this request were met by a full encashment of 400 segments then the chargeable gain would be £50,000 less £40,000 (the total premium paid on the 400 segments) i.e. £10,000. Assuming Mildred were a higher rate taxpayer, this would result in an income tax liability of £2,000 (40% X £10,000 less basic rate credit if appropriate of 20% X £10,000).

7. The examples above demonstrate that the method of withdrawal which produces the smallest gain is dependent on particular circumstances. However, it should be borne in mind that the smallest gain is not always the desired outcome. Whilst this will usually be the case, there may be good reasons why the policyholder may wish to use the method that produces the larger gain.

When does a surrender or part surrender become irrevocable?

8. Continuing with the example of George (example 1), suppose that he made his withdrawal by taking a partial withdrawal across all the segments but quickly realised that he would have done better to fully encash 80 of the segments and so wanted to change his mind.

9. Unfortunately the scope for doing so is quite limited. Once a surrender or part surrender of a policy has been completed, it cannot be reversed. HMRC guidance states that, the tax consequences must follow from the transaction which has happened, not those which in hindsight a policyholder might have preferred to have happened because they would have given a lower tax bill.

10. The only exception to this rule is if the insurer has clearly acted directly contrary to an instruction from the policyholder or from a person authorised to act for the policyholder in relation to the policy, such as an independent financial adviser.

11. HMRC Guidance IPTM 7325 states that "A surrender or part surrender of a policy is completed in law when the surrender payment is effective. It is effective when received by the policyholder. If payment is made by cheque then it might be possible for the policyholder to prevent completion of the surrender by sending back the cheque uncashed. But where the payment is by electronic transfer, the completion can only be prevented if it is possible to reverse the payment without the intervention of the policyholder before it reaches the policyholder's bank account. If this is not possible then the surrender will be effective as soon as the transfer is made."

12. In other words, the general principle is that a part surrender is completed once an insurer makes a surrender payment. This will normally be when a bank transfer is made or a cheque is issued. It is only in exceptional circumstances that completion can be prevented where a cheque has been issued. In such a case both parties must have agreed not to cash it.

13. Whilst the date of completion has no effect upon the date of a part surrender, a part surrender will not have occurred without the act of completion. Although receipt of the payment by the policyholder determines the completion of the surrender, it does not indicate its date. This depends on the terms of the policy or contract.

What does a provider need to do?

14. In simple terms, the provider needs to make sure that before a surrender or part surrender becomes irrevocable – i.e. is completed - the provider 'intervenes' to ensure the policyholder is put in a position to make an informed decision.

15. Although providers will want to give thought to the nature of the 'intervention', it is arguable that it is the fact of intervening and the timing of the intervention which is key.

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The Nature of the intervention

16. Although it might be supposed that withdrawal by full encashment of the necessary number of segments will give the optimal tax result, this is not necessarily the case (as example 2 above illustrates). Furthermore, as noted in paragraph 7 above, adopting the approach which gives the smallest gain may not always be the optimal approach for the policyholder and their circumstances may be such that it is perfectly sensible for them to use the method which will produce the larger gain. This illustrates the importance of the policyholder obtaining independent financial advice where appropriate – advice which the provider is not in a position to supply.

17. Therefore, as a minimum, providers should ensure that policyholders are informed that they should carefully consider their decision as the tax consequences can differ significantly depending on their choice. Beyond that providers could consider whether some or all of the following are also appropriate:
    - Suggesting, where appropriate, that the policyholder takes independent financial advice before making a decision
    - Providing appropriate information, illustrations etc. to help the policyholder make an informed decision. Providers are not expected to provide a range of client specific tax calculations.

18. However, it would not usually be appropriate for the provider to suggest which method a policyholder should adopt.

19. With the above in mind, providers may want to:
    - Review the wording of surrender request forms, telephone scripts and online material
    - Review the wording of new business documentation

Whether to intervene

20. Providers may want to intervene in every case where a policyholder wants to make a withdrawal from a cluster policy. Alternatively, providers should have risk assessment processes in place to ensure they identify those instances where it is possible that the choice of withdrawal method is likely to have a significant tax impact. Factors which a provider may want to take into account in their risk assessment process might include whether:
    - the withdrawal instruction explicitly states the method of surrender
    - the withdrawal instruction is received from a financial adviser or direct from the policyholder
    - the insurer's own request form has been used
    - the withdrawal instruction is open to interpretation
    - the withdrawal request triggers a gain which could be significantly mitigated using an alternative method of withdrawal.

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Timing of Intervention

21. The ideal time to intervene is at the point the policyholder wants to make a decision and as a general rule the closer the intervention to the decision the better. In contrast an intervention which merely comprises some illustrations provided to the policyholder at the time of taking out the bond (which could be many years in the past) is far less likely to be effective. It will therefore be apparent that the provider is likely to have a 'window' between the policyholder requesting a withdrawal and the withdrawal being completed when an intervention might be most effective.

22. The extent of this window will depend on the medium used for the request – for instance, whether in writing or by phone – and it could also be impacted by:
    - The risk of customer detriment where a customer has very urgent need of the money or where completing the withdrawal is delayed due to the intervention and the value of the policy(ies) moves against the customer in the meantime.
    - The terms and conditions of the bond - for instance, the terms may potentially prevent a provider querying an unequivocal written instruction before it is actioned. However, most terms and conditions specify a variety of requirements to be met before a part surrender request is actioned and this is likely to provide an appropriate basis for intervention.

23. Subject to the above and to any over-arching risk assessment framework, so far as is possible, providers should:
    - contact the policyholder on receipt of a written withdrawal request, to 'intervene' in accordance with paras 16-18 above before actioning the withdrawal
    - if the provider accepts telephone withdrawals, use the opportunity of the call to 'intervene' before actioning the withdrawal.

24. Although 'just in time' interventions are critical, providers should also consider including information about the implications of withdrawal choices with annual statements to policyholders as well as with initial policy documentation.

Training and procedures

25. Providers will need to ensure that procedures are in place and staff suitably trained to ensure the appropriate interventions are made. Effective training will be particularly important for those staff who are likely to receive requests for withdrawals over the telephone.

Default approach

26. As noted above, there is no guarantee that one particular approach will give the optimal tax outcome in every case. However, providers may feel that a default approach is appropriate to cover the situation where, for instance, a risk assessment has not picked up a relevant request or to address the situation where a provider is confronted with an urgent request for funds but is unable to contact the customer to intervene. If so, the existence of such an approach should be made clear in relevant literature.