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Insurance

WITHDRAWN

AGRICULTURAL ADJUSTMENT UNIT · UNIVERSITY OF NEWCASTLE UPON TYNE

Life Assurance in the Business of Farming

by Leo Menage, F.I.A.

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THE AGRICULTURAL ADJUSTMENT UNIT

THE UNIVERSITY OF NEWCASTLE UPON TYNE

In recent years the forces of change have been reshaping the whole economy and, in the process, the economic framework of our society has been subject to pressures from which the agricultural sector of the economy is not insulated. The rate of technical advance and innovation in agriculture has increased, generating inescapable economic forces. The organisation of production and marketing, as well as the social structure, come inevitably under stress.

In February 1966 the Agricultural Adjustment Unit was established within the Department of Agricultural Economics at the University of Newcastle upon Tyne. This was facilitated by a grant from the W. K. Kellogg Foundation at Battle Creek, Michigan, U.S.A. The purpose of the Unit is to collect and disseminate information concerning the changing role of agriculture in the British and Irish economies, in the belief that a better understanding of the problems and processes of change can lead to a smoother, less painful and more efficient adaptation to new conditions.

Publications

To achieve its major aim of disseminating information the Unit will be publishing a series of pamphlets, bulletins and books covering various aspects of agricultural adjustment. These publications will arise in a number of ways. They may report on special studies carried out by individuals; they may be the result of joint studies; they may be the reproduction of papers prepared in a particular context, but thought to be of more general interest.

The Unit would welcome comments on its publications and suggestions for future work. The Unit would also welcome approaches from other organisations and groups interested in the subject of agricultural adjustment. All such enquiries should be addressed to the Director of the Unit.

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PREFACE

"The Agricultural Development Association and the Agricultural Adjustment Unit together put on a one week course under the title 'Taxation, Partnership and Capital in Agriculture'.

Several of the papers prepared for this course dealt with technical and financial subjects in an authoritative way and it was decided to issue the papers so that a wider audience could benefit from the information which had been assembled."

December 1968

LIFE ASSURANCE IN THE BUSINESS OF FARMING

by Leo Menage, F.I.A.

1. "In this world nothing can be said to be certain, except death and taxes." Benjamin Franklin's epigram is desperately overworked: but the sentiment is so exactly right for my purpose that I hope I may be forgiven for pressing it into service. Sooner or later you are going to die, and if, when you die, you own assets worth more than £5,000, then - as the law stands at present - there will be a charge to estate duty. If the assets have increased in value since you acquired them (or since 6th April 1965 if you acquired them before that date) there may also be a charge to capital gains tax. To avoid a lot of repetition I shall in general in this paper refer simply to estate duty: but when I do so will you bear in mind that I also have one eye on capital gains tax.

2. I have dutifully inserted the phrase "as the law stands at present" in my first paragraph, and I ought to repeat it at intervals throughout the whole of this paper. This would be very tedious, so I propose to leave it out. But it is important to remember that the law affecting the estate duty payable on your death will be the law in force at the date of your death and this may be quite different from the law in force now. Any plans you make now must be based on the law in force now - that is the only basis available. But the fact that the law may change is one reason - not the only reason - for making your plans fairly flexible.

3. Other words and phrases which ought also to appear from time to time in this paper are "normally", "usually", "in most cases", "with certain exceptions", "in general", "in my opinion", and so on more or less ad infinitum. But most of the time I will leave them out. I shall try to be reasonably precise, but complete precision is unattainable in a reasonably short paper - and probably unattainable anyway.

4. You could eliminate the estate duty liability (but not the capital gains tax liability) by giving away most of your assets just seven years before the date of your death, retaining a sufficient amount to live one (no more and no less) during the seven year period. But this would be possible only if you knew in advance the date on which you were going to die. And you don't. Which is just as well. Life would be pretty intolerable if you knew it was going to end on 7th January, 1976 - or any other date for that matter, however remote.

5. The starting point for all your plans must be the knowledge that you may die within the next five minutes and - suppose you are now aged 30 - you may live for another 70 years. So when you think about providing funds for the payment of estate duty you are budgeting for a liability which may arise in the year 1969 and may not arise until the year 2039. This would be quite a problem - if it wasn't for life assurance.

6. But as this is a financial problem concerned with the duration of human life, you can be pretty sure that it is a problem which can be solved by taking out a life policy. This is one reason why any discussion of the impact of estate duty on farm estates is almost certain to involve life assurance. There are other reasons for turning to life assurance as I hope to show later.

7. But estate duty is only one part of my subject. I want to touch on all the ways in which life assurance is relevant to the business of farming.

8. I am now making a distinction between the business aspects of life assurance and the personal aspects of life assurance, and I am conscious at once that this is an artificial distinction. After all you do not conduct your farming business in a water-tight compartment as an end in itself. The object of the exercise is to provide a living for yourself and your family, and if you take out a life policy with a view to making sure that there will be a living for your family after your death (and this is the most fundamental reason for taking out a life assurance policy - this is really what life assurance is all about) then in my submission this is complementary to your farming activities, although most people would treat it as a personal transaction rather than a business transaction.

9. A life policy is very versatile and can perform many different functions. It has some of the characteristics of an insurance. It is arguable that your own experience and expertise is the most valuable asset on your farm, so that in taking out a life policy you are insuring a farm asset just as much as if you take out a fire insurance policy on your farm buildings. But it also has some of the characteristics of an investment. You are putting away money which in some circumstances you can draw on later for your own benefit.

10. A particular sort of life policy can be taken out for quite different reasons by different people. And the same life policy can perform at different times quite different functions for the same person. Thus the policy you take out for purely personal reasons with no thought of your farming enterprise, may at a later stage have an essential role to play in your business if - for example - you charge it to your bank as security for an overdraft or use it to help repay an A.M.C. mortgage.

11. I suspect that it is this very quality of versatility - which makes life assurance so valuable - which at the same time makes it seem to many people to mysterious. So I think it would help if, before considering the business uses of life assurance in greater detail, I cleared the ground somewhat by defining some of my jargon and giving a certain amount of straightforward factual information about life assurance in general. If you are already familiar with the subject you may prefer to skip the next few paragraphs and pick up the main argument again in paragraph 40.

SOME DEFINITIONS AND TYPES OF POLICY

12. A life policy is a contract (or the piece of paper setting out the terms of the contract) between yourself (the "policyholder") and the insurance company.

13. The premiums are the amounts which you pay (usually yearly or maybe monthly by banker's order) to the insurance company.

14. The sum assured is the amount which the company promises to pay on your survival or on your death - depending on the terms of the policy - provided that you have fulfilled your side of the bargain by paying the premiums to the company.

15. The surrender value is the cash sum (if any) which the insurance company will pay you if you elect to discontinue your life policy before it has run its full course. The surrender value may be less than the amount you have paid in premiums, it may be more, depending on the circumstances.

16. An endowment assurance is a policy providing for payment of the sum assured on your survival to an agreed age (say 65) or the end of an agreed term of years (say 25 years) with the proviso that if you die before the agreed age or before the end of the term of years, the sum assured will be paid at once. The payment of premiums ceases when payment of the sum assured becomes due.

17. The words "mature" and "maturity" are used universally to refer to payment of the sum assured on survival but only by lawyers (for some reason I have never understood) to refer to payment of the sum assured on death.

18. A whole life assurance is a policy providing for payment of the sum assured on death whenever that occurs - whether you die tomorrow or live to be 100. You can have a policy providing for payment of premiums as long as you live. But as it may be inconvenient to be still paying premiums when you are 99 it is more usual nowadays to have what is called a limited payment whole life assurance - that is to say a policy with premiums ceasing at an agreed age (say 65) or after an agreed number of years (say 25) - or of course on your previous death.

19. A term assurance (sometimes called a temporary assurance) is a policy providing for payment of the sum assured if you die within an agreed term of years - usually a fairly short term of years such as five years or seven years or ten years. Premiums are usually payable over the whole term of the policy, but may be payable for a shorter period. An important difference between on the one hand a term assurance and on the other hand an endowment assurance or whole life assurance is that under the term assurance the chances are that the insurance company will never have to pay the sum assured (unless you are very old when the policy is taken out). Under the endowment assurance or whole life assurance if you choose to pay all the premiums then the sum assured is bound to become payable.

LIFE ASSURANCE WITH PROFITS

20. If you take out a whole life assurance or an endowment assurance you can choose between a with profits policy and a without profits policy. A term assurance is always without profits. Most or all of the profits earned by an insurance company on its life assurance business is used to provide bonuses for those policyholders who have with profits policies. Bonus distributions take place every three years (or maybe more frequently) and the bonus added to a policy takes the form of an addition to the sum assured. Thus if you take out a with profits policy for a sum assured of £10,000 and after three years are allotted a bonus at the rate of three pounds per cent per annum your bonus will be £900. In effect you now have a policy with a sum assured of £10,900. The next bonus may be calculated with reference to £10,000 (in which case the bonus is called simple): it may be calculated with reference to £10,900 (in which case it is called compound). What you get at the end of the day depends of course on the profits earned by the insurance company, and not at all on whether it has a simple bonus system or a compound bonus system.

21. With profits policyholders get the benefit of the profits earned on without profits policies as well as the profits earned on with profits policies. This means that if you take out a without profits policy you are buying a product at something over cost price: if you take out a with profits policy you are buying a product at something under cost price.

22. Most of the profits earned by insurance companies on their life assurance business come from the investment of the funds which they hold on behalf of their policyholders. Most of the attractions of a with profits life policy arise from the successful way in which insurance companies handle these investments.

EQUITY LINKED LIFE ASSURANCE

23. An equity-linked life policy is a policy with the sum assured defined not simply as a cash sum, but as a benefit linked in some way to variations in the stock exchange prices of ordinary shares. A vast and confusing multiplicity of such policies is now available and new policies are spawned at the rate of two or three a month. The link with ordinary share prices frequently - but not necessarily - takes the form of relating the benefits to the performance of a unit trust. A vast amount of press publicity is at present devoted to the promotion of this type of life assurance and to promotion of the related unit trusts and the matter receives a corresponding amount of attention from financial journalists.

24. In view of all this publicity it seems hardly appropriate to write a paper of this sort without mentioning equity-linked life assurance. But having mentioned it I am not going to advocate it. I am advocating conventional life assurance, which - despite all the publicity - still accounts for about 90% of the new life policies taken out in the United Kingdom. It would be possible to write a complete paper arguing the merits and demerits

of equity-linked life assurance, and it would not be appropriate to go into any detail now. My view quite simply is that equity linked life assurance is speculative. This is not a condemnation. There is no harm in anyone indulging in a modest gamble if he has the means and the inclination. But in my submission any element of speculation is out of place in the context of business arrangements such as we are discussing. In my view the function of an insurance company is to undertake risks on behalf of its policyholders. The equity-linked life policy offends against this principle by leaving a large part of the risk with the policyholder. But I must emphasise that all this is an expression of a personal opinion on what is a controversial question.

25. That is all I am going to say in this paper about equity-linked life assurance: in the rest of this paper all references to life assurance are references to conventional life assurance.

WHO OWNS THE POLICY?

26. A life policy provides for payment of a sum assured on the death or survival of someone. The insurance jargon for that someone is the life assured. The person who takes out the policy is usually called the grantee (because he is the person to whom the insurance company grants the policy). In many cases the life assured and the grantee are one and the same person and this can be a perfectly satisfactory arrangement. But sometimes it is necessary or advisable for the grantee and the life assured to be different people. For example there are circumstances in which if you are the life assured it might be advisable for your wife to be the grantee: for example if she was paying the premiums out of her own income this would ensure there was no estate duty liability in respect of the policy on your death.

27. Another possibility is for ownership of the policy to be vested in trustees for the benefit of a beneficiary. If the beneficiary is to be your wife or one of your children all that is needed is to incorporate in the policy the magic words "for the benefit of Mary Jane Smith" - or whatever the name may be - and a trust automatically comes into existence by virtue of section 11 of the Married Women's Property Act, 1882.

28. The Married Women's Property Act, 1882 is one of the series of Acts of Parliament which enabled married women to own property and from most points of view is ancient history. But section 11 is very much alive and constitutes a sort of do-it-yourself kit to enable a man with the minimum formality to set up a trust in favour of his wife and/or children. There are various advantages in having a life policy in this form - for example the Act gives some measure of protection against the claims of creditors if the husband goes bankrupt and on death the insurance company can pay over the sum assured without waiting for probate of the policyholder's estate. But the main advantage is the favourable estate duty treatment which can arise where a life policy is in this form. I will discuss this in detail later on.

29. If a man wants a life policy in trust for the benefit of a beneficiary other than his wife or child - maybe his brother or his grandchild or his partner - this can be arranged but the magic wand of the Married Women's Property Act 1882 is not available. Legal documents have to be drawn up and it may be necessary to employ solicitors.

30. I should perhaps mention that there are disadvantages as well as advantages in arranging your life policy for the benefit of someone else: like marriage itself, arrangements of this sort are easier to get into than to get out of, and though you can retain some control over the situation by nominating yourself as one of the trustees of the life policy, the benefits of the life policy belong not to you but to the beneficiary.

31. When a policy is first taken out it belongs, in most cases, to the grantee (if there is a trust it belongs to the trustees). Subsequently the ownership of the policy can be transferred to some other person by assignment, either by way of gift or by way of sale or by way of mortgage.

THE TAX ADVANTAGES OF A LIFE POLICY

32. By putting money in a life policy you can obtain, directly or indirectly, a number of tax advantages.

33. The most obvious of these is a reduction in your own personal liability to income tax. If tax is paid at the full standard rate of 8/3d. in the £, relief of income tax is obtained at 8/3d. in the £ on 40% of the premium. This means the tax relief is 16½% of the premium - which is as near as maybe one sixth. A picturesque way of looking at this is to say that if you take out a life policy and pay monthly premiums it is only necessary to pay ten monthly premiums each year out of your own pocket - the other two will be paid on your behalf by the Inland Revenue!

34. Tax relief on life premiums is subject to the following list of conditions, which may at first glance look rather formidable, though in practice there is generally no difficulty in satisfying the conditions and getting the relief.

    (a) The policy must provide a capital sum on death.

    (b) The grantee must be the tax-payer or his wife.

    (c) The life assured must be the tax-payer or his wife.

    (d) Any excess of premium over 7% of the sum assured is disallowed for purposes of tax relief.

    (e) Any excess of premium over one sixth of the tax payer's income is disallowed for tax relief.

    (f) The policy must be a "qualifying policy" as defined in Section 16 and Schedule 9 of the Finance Act, 1968.

35. The Finance Act, 1968 is a remarkable specimen of the Parliamentary draughtsman's art and presents certain difficulties for the insurance companies who have to live with it and try to understand it. But in practice most life policies are "qualifying policies" and you can rely on your insurance company to see to it that the policy you take out will entitle you to tax relief - or at any rate to warn you if the policy you want will not qualify you for tax relief.

36. Another and slightly less obvious tax advantage of taking out a life policy arises from the way in which the insurance company is taxed. Most of the premiums you pay are invested, in effect for your benefit, in the insurance company's life assurance fund. The investments earn interest and this interest is taxed at a special rate of 7/6d. in the £. You benefit from this because if you were investing the money on your own behalf you would probably have to pay income tax at the full standard rate of 8/3d. in the £ and might have to pay surtax also.

37. Finally there is a tax advantage when the sum assured becomes payable on death or survival as the case may be: no capital gains tax is payable. This exemption from capital gains tax is given by Section 28 of the Finance Act, 1965, and is lost if at any time the policy changes hands for "a consideration in money or monies worth" - that is to say if the policy is bought or sold.

RETIREMENT ANNUITIES

38. A retirement annuity policy is a special sort of life policy giving extra special tax advantages. The policy is for the self-employed man (or the man in a non-pensionable job) who wants to save up to provide himself with an income after retirement. The policy has to satisfy a number of conditions laid down in the Finance Act, 1956. What these amount to is that the insurance company can make no payment whatever to the policyholder during his lifetime other than to pay him a pension commencing not earlier than his sixtieth birthday and not later than his seventieth birthday. In particular the insurance company cannot in any circumstances refund premiums, pay a surrender value, or make capital payment on retirement instead of paying a pension. Furthermore the policy cannot be assigned - so that it cannot be used as security for any sort of loan transaction.

39. Thus a retirement annuity policy lacks the versatility which makes an endowment assurance policy so worthwhile. Against this the tax advantages of a retirement annuity policy are much greater than those of an endowment assurance policy. Relief of income tax on premiums is just about double - about one third of the premium if you pay tax at 8/3d. in the £. In addition the surtax payer gets surtax relief on premiums for a retirement annuity policy: there is no surtax relief on premiums for any other sort of life policy. Premiums for retirement annuity policies are invested by the insurance company in a special section of its life assurance fund, and the interest earned on this part of the fund is entirely exampt from tax. Finally the pension payable to the policyholder is treated for income tax purposes as <u>earned</u> income and hence qualifies for <u>earned</u> income relief.

BUSINESS ASPECTS OF LIFE ASSURANCE

40. If you are still with me, having soldiered through my brief guide to life assurance in general - or having travelled by the short route without touching down between paragraph 11 and paragraph 40 - I can now get down to cataloguing and discussing those aspects of life assurance which seem to me to be relevant to the business of farming.

PENSIONS FOR EMPLOYEES

41. I start with the provision of pensions for employees because this seems to me to be business insurance pure and simple. It is the one life assurance transaction which a farmer can enter into which can never be of direct benefit to him personally. Any benefit he derives from entering into this sort of transaction comes to him indirectly, through his business, in the form of a more stable labour force, and improved staff relations and staff morale.

42. I may as well add that I am a bit suspicious of abstract ideas like 'staff morale' - and 'moral obligation', another phrase which sometimes crops up in this context. I think I would rather discuss the justification for providing pensions for employees in practical terms which have a more direct bearing on the profitability of the business. To say for example that if there is a pension scheme you can get rid of an elderly employee, when it is no longer an economic proposition to employ him without the risk of adverse comment which might be damaging to your business.

43. If you want to provide pensions for all your employees, your best plan may well be to become a subscriber to the N.F.U.'s Farm Pension Scheme.

44. Whether or not you subscribe in this way for pensions for all your employees, there is a lot to be said for making special provision for your farm manager or for any other key employee. The sort of question you need to ask yourself, in relation, say, to a man of 30 earning £20 a week, is: "shall I give this man another £1 a week in wages or shall I use that £1 a week to provide a pension of £x a week for him after age 65? Which of these alternatives is likely in the long run to be more conducive to the profitability of my business?"

45. If you want to provide a pension for one or more selected employees, the thing to consider is what the Inland Revenue call an "Individual Pension Arrangement" and insurance companies tend to call a "Top Hat Scheme" - "Top Hat" because once upon a time this arrangement was used in the main for the provision of pensions for senior executives and working directors of large companies, but in fact it is appropriate to employees from all classes of society, irrespective of head gear.

FARM FINANCE

46. If you are considering raising money on a long term basis, by mortgaging agricultural property, it is worthwhile exploring the possibility of borrowing the money from the Agricultural Mortgage Corporation and repaying it by means of an endowment assurance policy. This method of repaying A.M.C. mortgages has been available for less than two years - since April 1967 to be precise. Its popularity arises from the fact that in some circumstances it is almost certainly cheaper than the old method of repaying a mortgage by means of level half-yearly instalments each consisting partly of interest and partly of capital - particularly if a with profits endowment assurance policy is used.

47. The borrower who chooses the endowment assurance method of repayment gets the benefit of:

    (a) relief of income tax on the premiums (see paragraph 33)

    (b) the favourable tax treatment of the life assurance fund (see paragraph 36)

    (c) the investment expertise of the insurance company (see paragraph 22)

    In fact the higher the rate of tax paid by the borrower (income tax and surtax combined) the greater the relative advantage of the endowment assurance method of repayment.

48. If you are raising money on a short term basis, by means of a bank overdraft, you will find that your bank manager regards a life policy as a very acceptable form of security. It has two advantages from his point of view: (a) he knows that the loan will be cleared at once in the event of your death, since the bank will collect the sum assured from the insurance company, take what they want and pay over the balance to the estate - instead of having to claim on the estate for repayment of the loan and (b) during your lifetime the policy has a steadily increasing realisable value in the form of its surrender value.

49. Instead of using a life policy as security for an overdraft from your bank you can use it as security for a loan from the insurance company which issued it: it is normally possible to borrow in this way an amount equal to between 90% and 95% of the surrender value of the policy. The right to borrow on a life policy from the insurance company is usually guaranteed in the policy itself and hence the facility is available even in times of credit restriction when it may be more difficult to raise overdraft facilities.

50. Because it can be used as security for a loan, a life policy represents a useful reserve of value which can be drawn on in time of need. You may never need to draw on it but it is still performing a valuable function in being there - just as your fire extinguisher and your first aid kit perform a valuable function though you never use them.

PARTNERSHIPS

51. A special need for life assurance arises when two farmers are in business in partnership. The chances are that as a result of the terms of the partnership agreement, if one partner dies, the surviving partner can carry on the business only if he can raise sufficient funds to purchase the deceased partner's share of the business from the deceased partner's executors. So while both partners are alive and fit they ought to ensure that the necessary funds will be available when one of them dies.

52. This is just the sort of problem that can be solved by means of life assurance - and only by means of life assurance. It is not practicable in this paper to discuss in detail the various alternative life assurance arrangements which are available - it would be possible to write a complete paper on this subject alone. In broad terms the objectives are to take out life policies in such a form that

    (a) tax relief is secured on the premiums (see paragraph 33)

    (b) capital gains tax is not payable on the policy proceeds (see paragraph 37)

    (c) the most favourable estate duty treatment is obtained in respect of the policy itself and

    (d) the sum assured is payable to the right person.

53. The arrangement usually advocated is for each partner to take out a policy on his own life and to pay premiums on the policy himself, but to have the policy issued in trust for the benefit of the other partner. This probably secures all the four objectives mentioned above: other arrangements may secure only three of the objectives. For example, if each partner takes out a policy on the life of the other partner he will not secure tax relief on the premiums. If each partner takes out a policy on his own life and assigns it to his partner there may be capital gains tax on the policy proceeds - and so on.

54. The necessity for such complicated life assurance arrangements arises from the inclusion of certain conventional provisions in the partnership agreement and my personal view is that a better approach would be to have simpler life assurance arrangements coupled with different provisions in the partnership agreement.

55. The usual partnership agreement is designed to produce results which are equitable if there is no life assurance. The life assurance is then fitted round it. Surely it would be better to shape the partnership agreement and the life assurance arrangement together, as a single entity.

56. The objectives are to ensure that if one partner dies

    (a) his family shall have in cash the worth of his share of the business and

(b) the surviving partner shall own the whole business.

Objective (a) can be most easily secured if each partner takes out straightforward life assurance for the benefit of his family. Objective (b) can be most easily secured by amending the partnership agreement so that if one partner dies his share in the business passes not to his estate but to the surviving partner.

57. The conventional plan is to let the partnership look after the family at the expense of the business and then to have life assurance to look after the business. What I am advocating is to let the partnership look after the business leaving life assurance to fulfil its traditional role of looking after the family. This is probably controversial.

58. The discussion in the last four paragraphs illustrates fairly clearly the difficulty (mentioned in paragraph 8) of drawing a distinction between the business aspects of life assurance and the personal aspects of life assurance.

TAX LIABILITIES ON DEATH

59. I come now to the problem I touched on right at the start of this paper. It is simply this: how do you ensure that your farm can be handed over intact from one generation to another, despite the inroads of estate duty and capital gains tax.

60. May I say at once that there is no ready made solution to the problem which is applicable to all circumstances. In fact maybe it is not appropriate to talk of a "solution" at all, because that implies a set of once-and-for-all actions taken at a particular time which dispose of a problem in one fell swoop. I think that instead of this one has to recognise that situations vary over the years and cannot be predicted: the future is resolutely obscure. People may die. People may be born. The son who was going to take over the farm may decide to start a pop group. The daughter who was going to marry a farmer may become a nun. It is necessary to think rather in terms of a developing policy, of an attitude of mind, of a series of actions taken at intervals, with a mind open to the possibility of change to meet changing circumstances.

61. And the type and scale of the operations will vary with circumstances as well as varying from time to time. You must take into account the capital amounts involved; the income and outgo of the business; the ages of the people concerned; their state of health (a man who is fit can take out a life policy: a man who isn't, can't). And perhaps most important of all is the <u>temperament</u> of the people concerned. One man may be content to retire and hand over to his son. Another man might find this equivalent to suicide.

62. It is possible if you are not careful to get so obsessed with the urge to avoid taxes that you tie yourself up in elaborate and artificial legal knots which only your lawyer and your accountant really understand. For some

people this may be perfectly harmless.

63. But it is important to get one's priorities right and to know one's objectives. Opinions may differ about this: but if you think the object of life is living - living a full and happy and useful life - you may find this easier to achieve if you don't make too much of a fetish of tax avoidance. Maybe you can avoid estate duty altogether by sitting on a rock in the middle of the Atlantic Ocean. But will you be happy there? You may think that I am straying from my brief, but there is a danger in discussions of this sort of forgetting that people are people.

64. So when it comes to discussing the action which can - and should - be taken in advance, in good time, in anticipation of the impact of death duties - action which should be taken at the latest in middle age - I will consider first the man who accepts that on his death there will be a liability to estate duty to be met by his family, who does not propose to take any elaborate action during his lifetime to reduce that liability, but proposes instead to create funds which will enable his family to meet the liability - in part or in full - when the time comes.

ESTATE DUTY ON GIFTS

65. But may I first of all say something about the man who has really left it too late - the man who has reached his sixties or seventies without taking any action in anticipation of estate duty liabilities. There is no time left for him to build up funds for the payment of estate duty on his death: the only thing he can do is to divest himself of assets by making gifts to his family. And as you know this is not immediately effective. The liability to estate duty on the subject-matter of a gift continues after the date of the gift for a period which was increased by the Finance Act 1968 from 5 years to 7 years.

66. If I give you £10,000 today and die in the next four years you will have to pay estate duty on the £10,000. If I die on the fifth year after the date of the gift you pay duty on £8,500, in the sixth year on £7,000 and in the seventh year on £4,000. Once the seven years is up, I can die as much as I like and it won't cost you a penny. The 85%, 70% and 40% in the fifth, sixth and seventh years are sometimes referred to as the tapering provisions of the gift legislation. The rate of duty is that applicable to the whole of my estate - including the gift to you, and any other gifts I have made - so if I were a wealthy man you might have to think in terms of an estate duty rate of say 50%.

67. Two courses of action are open to you. You can keep your fingers crossed and do your best to keep me alive for seven years. Or you can take out a term assurance policy on my life (see paragraph 19) for the amount of the duty. A special policy is available, called an inter-vivos term assurance (as it is required in connection with what lawyers call a gift "inter-vivos"). The term is seven years and the sum assured (in my

example) £5,000 for 4 years, then £4,250, £3,500 and £2,000 in the last three years. You could pay an annual premium for six years. But it might be better to pay a single premium out of the gift of £10,000 you have received. It will depend on the amount of the premium whether this policy is worth having or not. Suppose the premium is £1,000. By taking the policy you substitute the virtual certainty of having £9,000 (the (virtual) gift of £10,000 less the premium of £1,000) for the chance of having £10,000 (if I survive) seven years but only £5,000 (the gift of £10,000 less £5,000 duty) if I die within four years.

68. Where a gift is made at an advanced age with a view to avoiding estate duty it is always worth considering protecting the gift with an inter-vivos term assurance policy. Such policies are sometimes available even if the donor is in his late seventies, if he is unusually fit for his age. But at advanced ages the premium is necessarily very high, and the game may not be worth the candle.

CREATING A FUND TO PAY DEATH DUTIES

69. I return now to the man in paragraph 64 - the man who is young enough to create a fund for the payment of estate duty. The only effective way of doing this - since the liability may arise tomorrow and may arise many years hence - is by taking out a whole life assurance policy. The amount of the sum assured will depend on a rough estimate of the present value of the property and hence a rough estimate of the duty which would be payable on it if death occurred now, taking into account current rates of estate duty and in particular the agricultural rebate of 45%.

70. The policy should be with profits, because the addition of bonuses over the years will go some way to meet

    (a) any liability to capital gains tax on death and

    (b) any additional estate duty liability arising as a result of increases in land value.

71. But an exact matching of life assurance provision against estate duty liability is so obviously impossible that it is futile to strive for it. The objective should be to make reasonable provision at a premium which is within your means. And since life assurance premium rates increase with increasing age, this means that the sooner the policy is taken out the better.

72. It is important to arrange the policy in such a way that the amount payable under the policy on your death does not itself become chargeable to estate duty, so aggravating the problem. The best way of achieving this is by taking out a policy in trust for the person who will inherit your property and so in effect be responsible for payment of the estate duty. This will probably be wife or son or daughter and if so the trust can be set up very simply by taking advantage of the provisions of the Married Women's Property Act 1882 (see paragraph 28). This is usually referred to as the MWPA.

ESTATE DUTY ON MWPA LIFE POLICIES

73. May I show why the amount payable on your death under an MWPA policy is likely to be exempt from duty? It is necessary to consider two Acts of Parliament.

74. Section 34(2) of the Finance Act 1959 says this: "Where by way of gift a person pays a premium under a policy of assurance on his life -- and -- the payment operates to keep up the policy for the benefit of another person (hereinafter referred to as "the donee") then for estate duty purposes the payment shall be treated as a gift to the donee of rights under the policy ---".

75. And Section 37(1) of the Finance Act 1968 exempts from estate duty liability a gift, "if it is shown to the satisfaction of the Board or, on an appeal under section 10 of the Finance Act 1894, of the court entertaining the appeal that the gift was part of the normal expenditure of the deceased, that the deceased made the gift out of his income and that, after allowing for all gifts forming part of his normal expenditure, the deceased was left with sufficient income to maintain his usual standard of living."

76. So by paying premiums on a policy for the benefit of someone else you are making "gifts of rights" under the policy and exemption from duty will apply to the whole policy if the premiums satisfy these conditions.

    (a) they must be part of your normal expenditure and

    (b) they must be paid out of income and must leave you with sufficient income to maintain your usual standard of living.

77. For our purpose we can forget about "normal". Normal is understood to mean "habitual" and the Estate Duty Office concede that in their very nature periodic premiums for a life policy are habitual.

78. So the exemption depends on your paying premiums out of income and on your having enough income to live on after the premiums have been paid. And these criteria need only be satisfied in respect of premiums paid in the seven years preceding your death. It doesn't matter what the situation was before that, because gifts made more than seven years before death are exempt from duty anyway (see paragraph 66).

79. These new rules for exempting from estate duty the amount payable on death under a straightforward life policy taken out by a man for the benefit of his family were introduced in 1968 and there has been no time to see precisely how they will work out in practice. But it is understood that the Estate Duty Office intend to interpret them in a reasonable fashion. They will look at a man's finances in the seven years prior to his death and if he has been able to pay his life premiums and meet his normal living expenses without recourse to capital and without recourse to borrowing, then the exemption will apply.

80. As the critical thing is the source of premium payments in the seven years preceding death, I would submit that it is advisable to take a policy with premiums ceasing at age 65. It seems to me that after age 65, there may be a tendency for a man's income to reduce, and a possibility that he will dip into capital to meet living expenses. If premiums are still payable this might have the effect of jeopardising the exemption from estate duty.

COMPLETE RETIREMENT AT AGE 65

81. But though it may be satisfactory to think in terms of remaining in the saddle for the whole of your life and using life assurance as a means of providing funds for the payment of estate duty whenever death occurs, it is probably better - if you are sufficiently strong-minded - to think in terms of eventually retiring completely from the business. I say "at age 65" because 65 seems a conventional sort of retirement age, but again it depends on individual circumstances. One man has had enough at 60 another is fighting fit at 70.

82. One good reason in favour of delaying retirement until age 65 is that under Section 34 of the Finance Act 1965 (transfer of business on retirement) you will be entitled to exemption from capital gains tax on the first £10,000 of chargeable capital gains - as the rate of duty is 30% this can mean a cash saving of £3,000.

83. I suspect that in practice you don't retain complete control until 65 and then disappear from the scene overnight. What happens in practice is probably that you hand over gradually, perhaps taking your son into partnership when he is in his twenties and over the years increasing his share of the business and reducing your own share of the business. But I cannot hope to follow through the details of every possible arrangement, and as I have said (paragraph 60) I think one should think in terms of a series of decisions over the years, each made in the light of current circumstances and in the light of what has gone before, rather than a master plan laid down in advance and followed slavishly.

84. So may I just content myself with indicating in a general way the sort of life assurance provision which seems appropriate if you intend retaining substantial assets until about age 65 and then divesting yourself of assets in favour of, let us say, your son. We have now got to consider two separate periods.

85. There is the pre-retirement period when you will have sufficient income from the business to live on but when your death would lead to a substantial estate duty liability.

86. And there is the post-retirement period when there is no longer an income from the business. From the point of view of estate duty the post-retirement period must be sub-divided into two sections. For seven years from the date of handing over (if handing over takes the form of a gift) there will be an estate duty liability if you die. Thereafter there will be no estate duty liability on your death.

A SUGGESTED SOLUTION

87. May I submit for your consideration my own suggested approach to this problem? I think it is original, in the sense that I thought of it myself. It may be of course that lots of other people have thought of it too! But I don't recollect coming across any reference to it. My suggestion - if you intend retiring at age 65 - is that you should take out an endowment assurance policy with profits under the MWPA for the benefit of your son.

88. If you die before age 65 the sum assured and bonuses will be payable to your son. The policy proceeds will probably be exempt from estate duty (see paragraphs 73 to 78) so the whole of the money will be available in your son's hands to pay estate duty on the property he inherits from you.

89. Suppose now that you survive to age 65. The sum assured and bonuses are paid not to you but to your son.

90. My suggestion is that he uses this money to buy your remaining farm assets from you. This means that the transfer of assets from you to your son is by way of sale and not by way of gift. Provided the sale is for full market value, there is no gift element in the transaction at all, and consequently no residual estate duty liability to consider in the event of your death in the seven years after retirement.

91. So the situation now is that your son owns the farm assets and you own the cash derived from the maturity of the policy. Out of this you can meet any capital gains tax liability in respect of assets which have increased in value since their acquisition or since 6th April 1965 as the case may be - remembering that the first £10,000 of capital gains will be exempt from tax as the charge to tax arises as a result of the transfer of assets on retirement.

92. The final stage in the suggested arrangement is to use most of the cash remaining in your hands after payment of capital gains tax to purchase from an insurance company an immediate annuity to provide an income for yourself and your wife for the remainder of your lifetime. I say most of the money should be used in this way - not all of it - because you will have much more independence and much more freedom of action if there is a few thousand pound in reserve to fall back on in time of need. But this will not lead to any great estate duty liability on your death.

93. Here are some of the advantages of the plan outlined above:

    (a) It is reasonably straightforward and easy to understand.

    (b) The policy on which it is based - a conventional with profits endowment assurance with a British life office - is perhaps the finest investment in the world.

    (c) Tax relief is obtained on the premiums and there is no capital gains tax or estate duty on the policy proceeds.

(d) The arrangement is flexible. With the concurrence of the beneficiary - the son in my example - the policy can be altered or even charged as security for a loan from the insurance company or an overdraft from a bank (though not used as a means of repaying an A.M.C. mortgage). Perhaps I should mention that I am thinking here of English law: different considerations arise in Scotland.

(e) The transfer of assets on retirement takes the form of sale not gift thus eliminating any residual estate duty liability.

(f) The maximum benefit is obtained from the capital gains tax concession which applies on retirement.

(g) The income after retirement is obtained by purchasing an immediate annuity and this means that part of the income after retirement is treated for tax purposes as a return of capital and so wholly exempt from income tax and surtax.

QUESTIONS OF HEALTH

94. The suggestions I have made so far have been based on your taking out a life policy and as you probably know this can only be done if you are in reasonably good health. If you are not in first class health it is sometimes possible for a life policy to be issued subject to payment of an extra premium but in some circumstances life assurance cover cannot be obtained on any terms at all.

95. If these circumstances arise, the best suggestion I can make is that you take out a retirement annuity policy (see paragraphs 38 and 39) with a view to providing yourself with an income after retirement, on the basis that at retirement you will hand over your assets to your son. This is not completely satisfactory but it may prove the basis for an arrangement that is better than nothing.

96. I think this underlines the importance of taking out the right sort of life assurance cover as early as possible, because the younger you are the more likely you are to be fit and able to take out a life policy on normal terms - and in any case the younger you are the lower the premium.

97. In fact, I would suggest that as part of the general approach to the problem of protecting intact the farm unit from the inroads of estate duty, it is advisable to think more than one generation ahead. If grandfather owns the farm he should clearly be concerned about the estate duty which may be payable when the property passes to father. But father should be thinking about the situation which will arise on his own death after he has inherited, even if he has nothing much in the way of assets at the present time. And he should also have in mind the next stage - the duty that will be paid on the death of his son after his son has inherited. I do not mean by this that any hard and fast scheme should be put into operation but merely that suitable life assurance cover should be arranged for the younger

members of a farming family. This should certainly be considered when they are in their early twenties but I would go further and suggest that the process should start when they are in their teens.

98. It is perhaps worth mentioning in this context that where it is too early to make a firm decision as to the sort of policy eventually required or where the cost of full cover on a whole life or endowment assurance basis may seem too much in relation to current income, there are various types of life policy available which in effect guarantee future insurability, and avoid the risk that when the time comes to take out the necessary life policy it cannot be obtained because of a deterioration in health.

CONCLUSION

99. I have tried in this paper to refer to those aspects of life assurance which seem to me relevant to the business of farming, with particular reference to the defensive measures which should be taken in anticipation of a charge to estate duty. I am conscious that the paper is full of generalisations and offers no package-deal solution to any particular problem. This I think is inevitable. No two situations are exactly alike. Each situation calls for individual diagnosis and prescription. All I can do is to indicate the framework within which this process takes place and the general principles which should be followed. When a tentative solution has been reached it may be felt that the premium for the suggested life policy is more than the farm income will stand. If so, it is better to make partial provision than no provision at all. But it is worth remembering that whatever it costs in life assurance premiums to provide in advance for the payment of estate duty, it may well cost three or four times as much in mortgage repayments if the money has to be borrowed on the security of the farm after the liability has arisen.

100. Finally a mixed bag of general principles. Obtain expert advice, but follow it only if you understand it and are sure it is sensible. Impartial advice is virtually unobtainable: most people have some sort of axe to grind. So in the end you must rely on your own judgement and in this field - as in most others - common sense is the surest guide. Avoid artificial arrangements which savour of tax avoidance and which consequently may be shot down by a future Chancellor of the Exchequer. This has happened before and will probably happen again. And most important of all, prefer what is simple to what is complicated, what is straightforward to what is devious and what is flexible to what is rigid.

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