Purchase of Preference Shares

BACKGROUND

London & Colonial Assurance PCC Plc ('LCA') is organised as a Protected Cell Company ('PCC'), and each unique protected cell ('Cell') of the company can have at least one preference share issued by LCA and attached to the Cell.

The option of acquiring a preference share enables any residual value, that may remain in the Cell following the death of the annuitant, to be available for the surviving family members and beneficiaries, and not to revert to the company issuing the policy. Please note there is no obligation for a preference share to be acquired. However, it is appropriate that the tax consequences of acquiring a preference share should be explained.

When an additional investment/top-up is made to an existing Flexible Life Annuity or Flexible Pension Annuity policy then it is not necessary to purchase another preference share.

The purpose of this note is to consider some of the ways the preference share may be held.

1. The Flexible Life Annuity

1.1 Policyholder buys the Preference Share and retains ownership throughout life

If the policyholder buys and holds the share, there would be no income arising from the preference share during their lifetime, because the preference share would only hold an expectation of value that might remain within the Cell upon their death.

If the policyholder still owned the share at the time of death, then the preference share would form part of his/her estate. Under current UK tax rules, if the policyholder has owned the preference share for at least two years at time of death, the value of the preference share qualifies for UK Business Relief. Business Relief is a UK Inheritance Tax ('IHT') relief that exempts the value of the preference share from IHT if the share is in an unquoted trading company and has been held for a minimum period of two years prior to death.

1.2 Policyholder buys the Preference Share and puts the share into Trust

The purchase of the share will have no immediate tax consequences. Provided the gift into trust occurs relatively close to the purchase of the share, there should be no significant capital gain and it is likely that if a gain arises at all, it will be well below the individual annual UK Capital Gains Tax allowance (£6,000 for the tax year 2023/24, reducing to £3,000 for the tax year 2024/25). However, if the gift takes place much later after the purchase, and particularly if there has been some life changing event, the gift may trigger a capital gain. This is because there is an increased risk that the value of the assets underlying the preference share will have increased over a period of time.

For Inheritance Tax purposes, if the gift into trust occurs soon after the purchase of the preference share, then it is most likely the gift will fall within the £3,000 annual IHT exemption. On each tenth anniversary of the trust, there may be a ten-year IHT charge at a maximum rate of 6% of the value of the assets in the trust (including the preference share). This is likely to happen only if the value of the assets in the trust at each tenth anniversary exceeds £325,000. The preference share may well qualify for Business Relief at each tenth anniversary assuming the trustees have held the share for at least two years and in such a case the preference share would not be the cause of or contribute to any ten-year charge imposed on the trustees. Professional guidance should still be taken however because circumstances exist where HM Revenue & Customs ('HMRC') may occasionally require a return to be made to report a ten-year charge even if the value of the preference share on the date of that anniversary plus the value of any other assets in the trust does not exceed £325,000.

1. The Flexible Life Annuity (continued)

1.3 Policyholder buys the Preference Share and gifts the share to heirs

The purchase of the share will have no immediate tax consequences. Provided the gift occurs relatively close to the purchase of the share, there should be no significant capital gain. However, if the gift takes place much later after the purchase, and particularly if there has been some life changing event, the gift may trigger a UK Capital Gains Tax charge.

If the gift occurs soon after the purchase of the preference share, then it is most likely the gift will fall within the £3,000 annual IHT exemption. If the share has acquired value but is given away within two years of purchase, any value transferred will become a UK Potentially Exempt Transfer (if the share at that time has a value of more than £3,000 and no other gifts in the same tax year have utilised the £3,000 exemption). If the individual dies within 7 years of the date of the gift, the value of the Potentially Exempt Transfer will be added to his/her estate for Inheritance Tax purposes and the heirs of his/her estate will be required to pay additional IHT. If, however the share is given away more than two years after its original purchase, the gift would qualify for Business Relief entirely and be exempt from IHT. In practice, it is expected the value of the preference share would remain low in most cases, on the basis the Flexible Life Annuity (‘FLA’) is paid in accordance with correct actuarial principles.

The recipient of the share will be deemed to have acquired the share at market value on the date of the gift. Any subsequent disposal of the share will trigger a gain for UK Capital Gains Tax purposes based upon the difference between the market value of the share at the date of disposal and its acquisition price.

Please note the guidance given in Paragraphs 1.1 to 1.3 above is on the assumption the amounts paid under the Flexible Life Annuity are in accordance with correct actuarial principles and no attempt is made to inflate the value of the preference share, for example by paying an annuity in a lesser amount than actuarial principles would recommend. Failure to observe this could lead to unexpected tax consequences arising.

2. The Flexible Pension Annuity

2.1 The structure of each Flexible Pension Annuity policy

Each Flexible Pension Annuity (‘FPA’) issued by LCA is held within its own protected cell and this follows from the principle LCA is structured as a Protected Cell Company (‘PCC’). In the case of the FPA, each Cell has a preference share allocated to it, and accordingly each FPA has its own preference share. The value of the preference share is equal to the present value of any assets left in the Cell at the time of death of the annuitant. At outset of the policy this is expected to be a very small value as the funds are expected to be exhausted at the time of death assuming the annuitant lives to their normal life expectancy. When the annuitant dies the value of the preference share increases to the value of any residual assets in the Cell at that time.

2.2 Annuitant buys the Preference Share and retains it throughout his life

The purchase of the preference share is a commercial transaction. By acquiring the preference share, the annuitant is ensuring that any residual assets in the Cell at time of death will pass to his/her estate. Provided the value of the preference share is actuarially assessed at the time of purchase, the potential funds may be denoted by the preference share at the time of death are not treated as payments to any survivor or beneficiary of the annuitant’s estate and are outside the scope of UK pension tax legislation.

If the annuitant still owned the preference share at the time of death, then the preference share would form part of his/her estate. Under current UK tax rules, if the annuitant has owned the preference share for at least two years at the time of death, the value of the preference share qualifies for UK Business Relief. Business Relief is a UK Inheritance Tax (‘IHT’) relief that exempts the value of the preference share from IHT if the share is an unquoted trading company and has been held for a minimum period of two years prior to death.

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2. The Flexible Pension Annuity (continued)

2.3 Annuitant buys the Preference Share and puts the share into Trust

The purchase of the share has no immediate tax consequences. Provided the gift into trust occurs relatively close to the purchase of the share, there should be no significant capital gain, and it is likely that if a gain arises at all, it will be well below the individual annual UK Capital Gains Tax allowance (£6,000 for the tax year 2023/24, reducing to £3,000 for the tax year 2024/25). However, if the gift takes place much later than the purchase, and particularly if there has been some life changing event, the gift may trigger a capital gain. This is because there is an increased risk the value of the assets underlying the preference share will have increased over a period of time.

For Inheritance Tax purposes, if the gift into trust occurs soon after the purchase of the preference share, then it is most likely the gift will fall within the £3,000 annual IHT exemption. On each tenth anniversary of the trust, there may be a ten-year IHT charge at a maximum rate of 6% of the value of the assets in the trust (including the preference share). This is likely to happen only if the value of the assets in the trust at each tenth anniversary exceeds £325,000. The preference share may well qualify for Business Relief at each tenth anniversary assuming the trustees have held the share for at least two years and in such a case the preference share would not be the cause of or contribute to any ten-year charge imposed on the trustees. Professional guidance should still be taken however because circumstances exist where HM Revenue & Customs ('HMRC') may occasionally require a return to be made to report a ten-year charge even if the value of the preference share on the date of the anniversary plus the value of any other assets in the trust does not exceed £325,000.

2.4 Annuitant buys the Preference Share and gifts the share to heirs

The purchase of the share will have no immediate tax consequences. Provided the gift occurs relatively close to the purchase of the share, there should be no significant capital gain. However, if the gift takes place much later after the purchase, and particularly if there has been some life changing event, the gift may trigger a UK Capital Gains Tax charge.

If the gift occurs soon after the purchase of the preference share, then it is likely the gift will fall within the £3,000 annual IHT exemption. If the share has acquired value but is given away within two years of purchase, any value transferred will become a UK Potentially Exempt Transfer (if the share at that time has a value of more than £3,000 and no other gifts in the same tax year have utilised the £3,000 exemption). If the individual dies within 7 years of the date of the gift, the value of the Potentially Exempt Transfer will be added to his/her estate for Inheritance Tax purposes and the heirs of his/her estate will be required to pay additional IHT. If, however the share is given away more than two years after its original purchase, the gift would qualify for Business Relief entirely and be exempt from IHT. In practice, it is expected the value of the preference share would remain low in most cases, on the basis the FPA is paid in accordance with correct actuarial principles.

The recipient of the share will be deemed to have acquired the share at market value on the date of the gift. Any subsequent disposal of the share will trigger a gain for UK Capital Gains Tax purposes based upon the market value of the share at the date of disposal and its acquisition price. at the date of disposal and its acquisition price.

Please note the guidance given in Paragraphs 2.1 to 2.4 above is on the assumption the amounts paid under the Flexible Pension Annuity are in accordance with correct actuarial principles and no attempt is made to inflate the value of the preference share, for example by paying an annuity under the pension in a lesser amount than actuarial principles would recommend. Failure to observe this may potentially also cause unwelcome Income Tax charges under the pension tax legislation to arise.

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SUMMARY

As can be seen, there are several possible options for purchasing and holding the preference share attaching to a Cell of LCA. The interaction between the different UK taxes means there may not be one perfect option, and careful consideration of an individual's circumstances is required. This note represents LCA's understanding of a limited number of options and does not constitute tax advice. Clients should always seek appropriate advice before embarking on a course of financial planning. In particular and under Options 1.2 and 1.3 concerning the Flexible Life Annuity, and under Options 2.3 and 2.4 concerning the Flexible Pension Annuity if the preference share is settled into a trust, or given away to an individual, at a time close to the expected death of the individual, tax risks may arise and specific advice should be taken in such circumstances.

This general information has been provided on the basis of our understanding of current legislation. Should any of the information provided be inaccurate, incomplete, or misleading, we take no responsibility for any reliance placed on it. We recommend individuals always seek specialist tax advice so their individual circumstances can be fully considered.

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