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TECHNICAL SALES BRIEFING

THE DANGER OF PARTIAL SURRENDERS AND RECTIFICATION ALLOWED IN THE LOBLER CASE

The following information is based on our interpretation of current law and taxation practice in the Isle of Man and the UK as at 1 January 2019.

- This technical briefing looks at the facts of a decision of a First-tier Tribunal case where large partial surrenders had been taken from a life assurance policy.
- Despite the First-tier Tribunal reluctantly dismissing the appeal, the decision in the Upper Tribunal has held the taxpayer made a mistake for which rectification is available.
- The decision deals with the remarkably unfair tax result that arose from a combination of prescriptive legislation and the policyholders ill-advised actions in withdrawing funds from his policy.
- Despite the decision, and subsequent consultations on the subject resulting in new legislation on this subject, great care should be taken and appropriate advice sought, before withdrawing funds from life assurance policies.

INTRODUCTION

In an interesting addition to the on-going debate on the fairness of the tax system and the obligation to pay a "fair amount" of tax, the Upper Tribunal (Mrs Justice Proudman DBE) in a ruling released on 26 March 2015 has held that the taxpayer in the case of Joost Lobler made a "mistake" for which rectification is available.

Mr Lobler had purchased a life assurance bond, and had subsequently withdrawn funds by way of partial surrender across all policies from specific funds. He thus incurred a substantial tax charge under the chargeable event legislation set out in Chapter 9 of the Income Tax (Trading & Other Income) Act 2005 (ITTOIA 2005) that governs such bonds.

The First-tier Tribunal had reluctantly dismissed Mr Lobler's appeal, pointing out that there are situations where taxpayers, far from avoiding tax, are subject to an unfair amount of tax. A further appeal was launched and, armed with more arguments from several counsel, the Upper Tribunal held that this was a suitable case for rectification, and that the partial withdrawal could be turned into a full withdrawal, in which case the tax is linked to the investment return.

Mr Lobler's appeal was allowed on that ground alone; all his arguments based on public law and human rights grounds were dismissed.

THE LOBLER CASE

The following facts of the case are taken from the reported decision:

Mr Lobler and his family are Dutch. Early in 2004 he moved with his family to England for work. In 2005 they sold their house in Holland and the proceeds – all Mr Lobler's life savings, about £350,000 – were invested in a life insurance policy (or series of policies) with Zurich Life, a life insurance company in the Isle of Man.

The investment was converted into roughly US$700,000 and was supplemented by a loan from HSBC of another US$700,000. His total investment in the policy amounted to about US$1,406,000 invested on 1 March 2006 in 100 life insurance policies.

The bond had been arranged for Mr Lobler by HSBC Private Banking. Mr Lobler had told them about his situation and his future plans and assumed thereafter that he did not need any further independent advice. He took no advice before withdrawing funds from the policies.

In 2006 Mr Lobler bought a house in England. He started to withdraw funds from the policy. First he withdrew US$746,485 on 28 February 2007. This he used to repay the loan from HSBC of US$700,000 plus interest. Then on 29 February 2008 he withdrew a further US$690,171. This he used to pay for his house and renovation works.

He withdrew the monies from the policies by completing a form provided by Zurich. The form contained four surrender options. Option A was for full surrender, option B was for partial surrender across all policies and funds, option C was for partial surrender across all policies from specific funds, and option D was for full surrender of individual policies. Mr Lobler elected for option C: he put an "X" in the box opposite the words "partial surrender across all policies from specific funds"; he put the amount he wished to raise in the next box and indicated the funds from which the withdrawal should be made in the following section.

The monies were subsequently paid to him. Mr Lobler assumed that, because he had withdrawn no more than he had paid for the policies, no taxable gain would arise. He made no mention of the monies in his tax returns. But in pursuance of its legal obligations, Zurich wrote to HMRC and Mr Lobler following each withdrawal indicating the amounts which represented taxable income arising on each of the withdrawals. Those amounts were US$676,184 in the case of the 28 February 2007 withdrawal and US$619,871 in the case of the 29 February 2008 withdrawal.

HMRC opened enquiries in relation to Mr Lobler's self-assessment returns for the years ending on 5 April 2007 and 2008 and, on the closure of the enquiries, amended the assessments to include amounts to be treated as income arising from the withdrawals from the policies.

Under the legislation, in the case of partial surrenders, amounts withdrawn in excess of the 5% per annum tax deferred entitlements (based on the investment amount) are treated as chargeable gains. Mr Lobler had incurred deemed gains of roughly US$1.3m, and was assessed to tax accordingly. This represents an effective tax rate of 779% on actual income generated by the policy.

Mr Lobler says he made a mistake in the way in which he withdrew funds from the policies. He did not realise that the effect of making a partial surrender was that almost all the amounts he withdrew would be treated as taxable income.

THE DECISION

In its judgement, the First tier-Tribunal considered the rules relating to the partial surrender of life assurance policies. The effect of these rules was that income tax was charged on virtually the whole amount withdrawn, although this was largely the return of the original investment and could not be said to represent a profit. Although Mr Lobler was granted deficiency relief when he subsequently terminated the policies in July 2008, the loss was of no practical use to him as he did not have sufficient income to absorb it.

The tribunal made the point that the appeal was taking place at a time when there is great media and political comment about a fair tax system and it took the view that, despite the case potentially producing an "outrageously unfair result", the highly prescriptive nature of the legislation meant it could not help the taxpayer.

However, it was felt that there were three main grounds of appeal to the Upper Tribunal: firstly, private law grounds (including the doctrine of mistake at common law, the doctrine of mistake in equity, and the remedy of rectification); secondly, human rights grounds in private law; and, thirdly, public law grounds (including jurisdiction of the First-tier Tribunal, and alleged ultra vires acts by HMRC).

The appeal was allowed on the ground of rectification alone; all the other arguments based on public law (essentially the legislation itself) and human rights grounds were dismissed.

Paragraph 69 from the ruling is worth quoting: *"There is no doubt that Mr Lobler would not have instructed Zurich in terms of a partial withdrawal had he known about the devastating tax consequences of his choice of withdrawal method. It is common sense that nobody would willingly contract to pay an amount of tax that would effectively lead to his own bankruptcy if there were a choice not to do so and achieve the same goal. It is therefore clear to me that the mistake made by Mr Lobler is of a sufficiently serious nature…to warrant rescission and thus rectification"* (paragraph 68).

FURTHER ACTION

Following the Upper Tribunal's decision in this case, an HMRC consultation was announced to consider possible changes to the position.

Three potential solutions were suggested in the consultation and each would have made a repeat of the Lobler case unlikely. However, resistance came from the insurance industry as the solutions would have had severe impact on policies already in force.

RESOLUTION

On the back of the consultation, HMRC decided not to make any amendments to the chargeable event legislation to prevent this type of situation recurring.

Instead, legislation has now been introduced which allows for rectification where a part surrender produces a "wholly disproportionate" gain.

HMRC have stated no set criteria for what they will deem to be "wholly disproportionate". Instead they will make a detailed examination of the circumstances of each case, with particular attention to the following three areas:

- the economic gain on the rights surrendered or assigned
- the amount of the premiums paid under the policy or contract
- the amount of tax that would be chargeable if the gain were not recalculated

Applications to HMRC must be made within four years of the end of the tax year in which the gain arose. After this period has passed, HMRC can still consider applications in exceptional circumstances.

The application must be made by 'interested persons'. An 'interested person' is a person who would be liable to all or part of the tax on the gain arising from the part surrender or part assignment. Where there is more than one interested person then all interested persons must make the application together. This includes all policyholders if the policy is jointly held and both the assignor and assignee where the policy has been part assigned.

Where a recalculation is made HMRC will only notify the policyholder(s) of it.

As the insurer will not be provided the information and will not be able to reissue certificates, it is imperative that policyholders maintain sufficient records for themselves. This will be important so that they can accurately calculate gains arising when the policy is terminated as their insurers will be unable to calculate these gains on their behalf once the first recalculation has been made.

COMMENT

The decision given in the Upper Tribunal is, arguably, a victory for common sense, and in a sense it is reassuring to know that the courts can achieve a just outcome in the end. Further, the legislative changes HMRC have made to try and prevent this happening again represent a pragmatic approach.

However, it is important to recognise that the whole situation could have been avoided for Mr Lobler if he had taken appropriate advice before withdrawing funds from his bond. The lesson learned from this case is to ensure that the full tax consequences of any proposed action are fully considered by the policyholder before they take place. If in doubt always seek professional advice.

TECHNICAL SERVICES
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