

Capital Option

Simplified taxation guide

An overview for advisers

Group Income Protection

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This guide was originally prepared by Ernst & Young LLP at the request of Unum, and has since been updated to take account of changes to retirement benefits tax law that took effect on 6th April 2006. It has been designed to give you (the IFA) general guidance on the Human Resource, Legal and Taxation issues that may affect your client (the employer) when they purchase our Group Income Protection product 'Capital Option'.

Unum recommends that your client obtains specific professional advice on the matters discussed within this document, before considering how best to proceed. This document is intended to provide generic guidance only, and as such, Unum cannot accept responsibility for any legal, taxation or other liabilities that may arise.

1. What is Capital Option?

Capital Option from Unum provides you with a real alternative to deal with the challenges your clients face when managing longer-term employee absence due to illness or injury.

Under Capital Option, premiums are paid by the employer and income protection benefit is provided for 2, 3 or 5 years, followed by a lump sum (payable to the employer) which the employer might decide to use, for example, to finance early retirement or other leaving service benefits for an employee who is unable to work. Rehabilitation is an integral part of the package, and wherever possible our expert medical and rehabilitation teams will work with the employee and employer to bring about a successful return to work.

The regular income benefit lets your client provide continued income to employees during a period when they are unable to work due to illness or injury. The regular income benefit helps your client meet any contractual financial responsibilities, whilst reducing financial strain on their business, until the employee can return to work.

However, if the employee is unable to return to work within the selected income benefit period, your client will be facing some difficult decisions. As a caring employer, they may want to provide some continuing level of support to their employee. However, from a commercial perspective they may need to give serious consideration to releasing the employee from the payroll. Capital Option can help in both of these situations.

2. What do I need to know about Capital Option in order to advise my clients?

Unlike conventional Group Income Protection schemes, Capital Option provides a lump sum payment, which your client can use either within a contractual framework or at their discretion. Your client may therefore need to consider some or all of the following:

- i) human resource issues (including employee communications and employment law)
- ii) legal considerations (including contract of employment and third party rights)
- iii) taxation matters (impacting on both employer and employee).

In the first instance, your client is likely to consult you, their insurance adviser, with regard to the taxation and legal considerations of the product. This guide contains a summary of the information you may require.

3. Human Resource issues

3.1 Employee communications

Your client needs to consider how best to communicate details of the benefits that they provide to their employees. They are likely to look to you to help design a suitable announcement letter. But remember that although the lump sum may ultimately be used for the employee's benefit, it is essentially a payment to assist your client at the end of the selected income benefit period. Consequently, care should be taken to ensure that employees are not provided with information that implies they have any contractual right to the lump sum payment, where that is not the case.

3.2 Contractual or discretionary arrangement?

Your client will need to decide how they intend to provide the lump sum:

Contractual basis:

The advantage of a contractual route is that your client can offer specific benefits to their employees, which are perceived to be a valuable addition to their overall benefits package. However, your client must be aware that a contractual approach is also a more complex solution. This approach can make it more difficult for your client to change their policy with regard to absence benefit changes arising from longer term illness or injury sustained by their employees. Your client will have a more onerous responsibility because they will be bound by the contractual arrangements that are put into place.

Discretionary basis:

The discretionary route, although less transparent to employees, allows your client greater flexibility in using the lump sum, without being bound to any contractual terms. It is also simpler to establish.

3.3 Guidance on the provision of the lump sum on a contractual basis

Where your client is considering providing the lump sum on a contractual basis, they will need to give some thought as to how the contract of employment and scheme announcement letter are not only constructed, but also interpreted by their employees. They also need to consider the legal and taxation implications.

Providing employee benefits has several purposes including the need to enhance employer/employee relationships, encourage better employee retention, and aid recruitment. Any reference to concepts such as 'early retirement' or 'termination' must use the correct and appropriate language, which is not only important from a legal perspective, but also from a motivational one. Your client will therefore need to seek guidance from their own HR departments, or seek external professional assistance if such facilities are not available to them.

4. Legal considerations

4.1 Contract of employment

Your client needs to carefully consider the wording used in their contract of employment to make sure that it correctly communicates and evidences not only the employees' responsibilities but also the remuneration and benefits that they will be receiving. Care must be taken that the wording does not place unintended and onerous responsibilities or liabilities on your client.

Your client will need to consider the approach that they wish to adopt with regards to payment of the lump sum; specifically, whether this is to be discretionary or contractual in nature. The table on page 5 highlights certain key areas.

4.2 Contracts (Rights of Third Parties) Act 1999

The Capital Option contract is between Unum and your client. However, the Contracts (Rights of Third Parties) Act 1999 automatically provides employees with contractual rights by default. This decision with regard to third party rights must be documented within the policy. The options your client has in regard to these rights are as follows:

Full Third Party Rights:

Allowing full contractual rights to employees is considered to be undesirable by most employers

because it can impact on their autonomy to properly run and control the scheme.

Standard Third Party Rights:

In normal circumstances, Unum will establish Capital Option on the basis that the employee has NO contractual rights other than rights that apply following a claim where Unum's liability is under dispute.

No Third Party Rights:

Employers may choose that no employee contractual rights will apply.

Subject	Discretionary basis	Contractual basis
Contract of employment	Your client's standard contract of employment should be reviewed to ensure that it is adequate.	The contract of employment may need to be specially drafted to take into account the contractual promise of a potential lump sum following longer term illness.
Scheme announcement letter	This should either be silent with regards to the lump sum, or only referred to generically.	The scheme announcement letter will require careful drafting and review by HR & Legal Departments.
Termination of employment/early retirement package	Because there is no contractual position, your client need only investigate these options at the appropriate time, and is free to discuss all options with employees.	The position will need to be formalised and accepted by employees at outset. Thereafter, your client will normally be bound by the contractual arrangement.
Taxation of the lump sum	The taxation position can be examined at the appropriate time.	Taxation treatment of the lump sum may need to be explored in advance and explained to employees in writing.
<p>NOTE: Details of the lump sum will be shown within the Capital Option policy documentation, which the employee will have the right to examine. In view of this, your client may feel it appropriate to provide some reference to this, within their announcement letter (see: Employee communications – section 3.1)</p>		

5. Taxation

The lump sum will be paid direct to your client (the employer). Some, none, or all of this can then be passed on to their employee. However, the tax treatment of the lump sum depends upon how the payment is used and the timing of payments. There can be tax consequences for both your client and their employees, therefore it is recommended that appropriate professional tax advice is taken in good time before payment of the lump sum is made by Unum. The treatment of premiums for corporation tax purposes will also need to be considered, together with any taxation implications for employees on some or all of the premiums paid by your client.

Your client will need to consider whether:

- i) any lump sum payment to their employees will be wholly discretionary, paid automatically, or contractual in nature
- ii) any contractual payment is linked to termination of employment
- iii) any contractual payment is linked to early retirement
- iv) a proportion of premiums paid relating to that part providing the lump sum could be taxable on employees as a 'P11D' benefit in kind
- v) premiums are either fully or partly allowable against any liability for corporation tax.

In instances where Unum pays your client the lump sum and your client uses (all or part of) it to pay the employer's ordinary annual contributions into an exempt approved pension fund, your client will be able to deduct the full amount of the contribution as a business expense. A special contribution to such a fund should also qualify for a tax deduction, but the Revenue might require the deduction to be spread over a number of years.

Detailed tax guidance notes are available from Unum upon request. The details provided here are intended to provide only general guidance about the likely UK income tax and corporation tax treatment of premiums paid and benefits provided, and the information provided may not necessarily be appropriate to your clients' or their employees' circumstances. Specific advice should therefore always be sought from an appropriate taxation specialist.

5.1 Steps to take in order to secure a tax-free lump sum

The following points address the consideration that should be given before advising your client that the lump sum will be tax-free:

- i) it would be ideal to obtain the Inland Revenue's views on the tax treatment of the lump sum payment before employer and employee are irrevocably committed to the severance agreement.
- ii) this gives rise to a serious problem. At the time of writing the Inland Revenue have a policy of not giving what they call "pre transaction rulings". Thus, on the face of it, the employer and employee cannot obtain the comfort, which they need about the tax treatment of the payment until they are irrevocably committed to the agreement.
- iii) it might be possible to resolve this difficulty by, for example, entering into an agreement which contains an escape clause which would void or vary the agreement if the Inland Revenue disagreed with the employer's and employee's view that the payment was completely tax-free.

iv) once such an agreement had been signed, but before the payment under it was due, the Inland Revenue could be asked to give what would by that time be a "post transaction ruling". At the time of writing the Inland Revenue is willing to give such rulings.

v) to test the proposition that the lump sum payment is tax-free because it is made on account of disability, the Revenue will:

- consider whether the employee had a contractual right to the payment, or automatic expectation of receiving it;
- ask to see the medical evidence, and seek a second opinion on it from their own medical adviser; they may even propose that their adviser should carry out a further physical examination of the employee;
- look for reasons other than disability for which the payment has been made. For this reason it is important to determine what other claims the employee might have in connection with the termination of their employment and attribute a separate amount to these claims.

5.2 Tax Table

The Capital Option Tax Table on page 7 is only relevant if you can answer 'yes' to ALL of the following points:

- your client has a business where the profits are subject to UK income tax or corporation tax, and where the employees covered by the scheme, work in or for the benefit of that business
- the premiums of the policy are paid in full by the business
- all or part of the lump sum is paid to the employee and their service is terminated
- your client has provided the lump sum under the discretionary basis but has not adopted any practice that could be construed as customary.

Note: a lump sum payment which, although discretionary, is almost invariably made in given circumstances is likely to be treated for tax purposes like a contractual payment.

Capital Option Tax Table

Subject	Discretionary basis	Contractual basis
1. Treatment of your client's premiums as a business expense	Premiums should normally be deductible in calculating the UK taxable profits of the business.	Premiums should normally be deductible in calculating the UK taxable profits of the business.
2. Tax treatment on employee of premiums paid by your client	Premiums do not give rise to any UK tax consequences for employees, even if the benefits under the policy are payable direct to incapacitated employees.	This amount does not give rise to any UK tax consequences for employees, even if the benefits under the policy are payable direct to incapacitated employees. Class 1 NICs would be payable on this part of the premium.
3. Treatment of annual income and lump sum benefit paid to your client by Unum	The benefits payable to your client are likely to be treated as taxable receipts of your client's business.	The benefits payable to your client are likely to be treated as taxable receipts of your client's business.
4. Treatment of annual income benefit paid by your client to his/her employees for 2, 3 or 5 years	<p>Your client's UK tax position</p> <p>Your client should be able to obtain a tax deduction for the payments he/she makes to the incapacitated employees if the payments are either required by the employment contract or are the usual practice of your client.</p> <p>Employee's UK tax position</p> <p>The payments received by the employees are treated for UK tax purposes as earnings from their employment. They are subject to PAYE and NIC deductions.</p>	<p>Your client's UK tax position</p> <p>Your client should be able to obtain a tax deduction for the payments he/she makes to the incapacitated employees if the payments are either required by the employment contract or are the usual practice of your client.</p> <p>Employee's UK tax position</p> <p>The payments received by the employees are treated for UK tax purposes as earnings from their employment. They are subject to PAYE and NIC deductions.</p>
5. Treatment of the lump sum	<ul style="list-style-type: none"> • If the employee has no right to a lump sum from your client and your client has no automatic practice of paying one, the Inland Revenue might seek to tax the lump sum in full as an ex gratia payment on retirement. • To rebut that claim, your client would have to be able to show that the decision to make the payment was made not in connection with retirement, but on account of the employee's disability. • The fact that your client makes a one-off decision in each case whether or not to make a payment would support that line of argument. • The element of the termination payment that relates solely to termination because of the employee's medical condition should be wholly tax-free, even if it exceeds the normal £30,000 limit on tax-free termination payments (See 'Steps to take in order to secure a tax-free lump sum' – section 5.1). • On the face of it, the employer could pay this element of the termination package tax-free, even if it exceeds the £30,000 tax-free limit that normally applies. However, employers need to take great care before deciding that they can pay gross. • If your client makes a payment of (say) £200,000 tax-free, and the Inland Revenue is subsequently successful with a claim that £170,000 of the payment is taxable, then your client is liable for the PAYE (and possibly NIC) it should have deducted from the £170,000, and might have no legal right to recover it from the employee. 	<ul style="list-style-type: none"> • The lump sum benefit will not be chargeable as employment income because benefits in respect of the ill-health or disablement of an employee during service is excluded from the usual charge on benefits from a non tax-approved retirement benefits scheme. • There will be no charge, as a payment on termination of employment, provided that the payment is made on account of injury or disability.

For further information on Capital Option, please contact your local sales office. Details on reverse.

About Unum

Unum is the UK's leading provider of group income protection insurance, with over 35 years of experience. Our critical illness and life insurance products enable our customers to purchase complementary protection solutions that together make up a comprehensive protection package.

Our income protection customers benefit from our expertise in the specialist areas of disability, rehabilitation and return-to-work. We enable individuals to protect their incomes, ensuring their financial security if they are unable to work because of illness or injury. For employers, we offer Group Income Protection policies which provide insurance cover for employees' salaries and safeguard one of their most valuable resources by helping employees return to work following long-term absence.

At the end of 2006, Unum protected almost 2 million lives through more than 18,600 schemes. During 2006 we paid total benefit claims of £285 million – of which more than £191 million related to income protection claims.

Our US parent company, Unum Group, traces its history back to 1848 and is today the market leader of group and individual income protection insurance in the United States. Premium income for Unum Group and its subsidiaries exceeded \$7.9 billion in the year ended 31 December 2006. Total assets were \$52.8 billion at 31 December 2006.

For more information please visit

www.unum.co.uk

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We monitor telephone conversations and e-mail communications from time to time for the purposes of training and in the interests of continually improving the quality of service we provide.

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