

# 5 The legal, regulatory and taxation environment

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## Consumer rights

5.1. ‘Extended warranty’ is not a term with a technical meaning in English law.<sup>1</sup> The reference provides a meaning for the term ‘extended warranty’ which focuses on the contractual provision of cover against certain costs,<sup>2</sup> being the costs of repair or replacement of DEGs.

5.2. In the terms of reference, the cover provided by the extended warranty must extend ‘beyond that covered by a manufacturer’s, retailer’s or importer’s guarantee’. No definition of these sorts of guarantee is provided,<sup>3</sup> but we believe that it is a reference to the statements frequently provided with goods on their sale to the effect that the manufacturer, retailer or importer will, subject to limitations, stand behind the quality of the goods to some extent for a certain period. The terms of guarantees vary with the manufacturer. Typically, the guarantor may promise to replace defective parts without charge, or to replace the goods if the goods fail and the replacement of parts is not the answer. Such replacement will be free of charge. However, the costs of transportation of the parts, and of labour, may or may not be met by the manufacturer.

5.3. In the course of our inquiry we have encountered a variety of contracts that fall within the meaning of extended warranty provided in the reference. Some of these contracts state on their face that they are contracts of insurance, the majority do not. We have heard submissions from the FSA, pursuant to its consultation document *Consultation on Draft Guidance on the Identification of Contracts of Insurance*. These submissions suggest that some EWs that operate as service contracts may in fact be contracts of insurance. The identification of a contract of insurance, and its consequences, are discussed more fully in paragraphs 5.30 and 5.31, together with other aspects of insurance regulation. However, save where indicated in the report, we have not in this inquiry been concerned with whether or not a contract is one of insurance.

5.4. The primary concern of this chapter is not with EWs, or their particular terms, but with the rights of consumers who purchase DEGs. Under this heading we summarize briefly<sup>4</sup> the more important rights of a consumer who has been supplied with goods by a person in the course of their business. We also review briefly some developments in EC law which may in the future change the rights of consumers in the UK.

5.5. The starting point in any discussion on the rights of a buyer who has purchased goods is the maxim ‘let the buyer beware’ or *caveat emptor*. This fundamental common law rule establishes that it is for the purchaser of goods to satisfy himself that the goods meet his requirements as to their quality. However, the principle of *caveat emptor* is subject to substantial qualification. The vendor of goods may agree terms of sale with the purchaser which vary the operation of the rule. More importantly, statute may intervene to imply terms into a contract for the sale of goods.

## The Sale of Goods Act 1979

5.6. The Sale of Goods Act 1979 (the Sale of Goods Act) gives consumers important rights which supplement those that arise by virtue of the bargain the consumer strikes with a vendor of goods. Those rights have recently been supplemented by The Sale and Supply of Goods to Consumers Regulations

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<sup>1</sup>‘Warranty’ is a term with a number of distinct but different meanings. In the Sale of Goods Act 1979 ‘warranty’ is defined as ‘... an agreement with reference to goods which are the subject of a contract of sale, but collateral to the main purpose of such contract, the breach of which gives rise to a claim for damages, but not to a right to reject the goods and treat the contract as repudiated’. A different use of the term is displayed in the classification of contractual terms, where a ‘warranty’ is distinguished from a ‘condition’. In this usage, breach of a ‘warranty’ gives rise to a right to damages, whereas breach of a ‘condition’ gives the injured party the right to rescind the contract. A further approach to the meaning of ‘warranty’ is to say that it is simply a statement relating to goods regarded as giving rise to legal liability. Of all these meanings of warranty, that provided by the Sale of Goods Act is closest to the meaning of ‘extended warranty’ in the reference. Most, but by no means all, of the EWs we have seen are agreements made at the same time, or close to the same time, as a contract for the sale and purchase of domestic electrical goods. The extended warranty is normally a separate contract to the contract of sale.

<sup>2</sup>Rather than on the provision of cover against the incidents giving rise to those costs, such as breakdown, accidental damage or theft.

<sup>3</sup>The reference to a ‘guarantee’, at least in the case of a manufacturer’s guarantee is not a reference to a guarantee as that term is usually understood in law. In law, a contract of guarantee is a contract by which one person, the guarantor, makes himself or herself liable to answer for the default of another.

<sup>4</sup>There are numerous works which explain the position of the consumer in a sale of goods. See, for example, *Benjamin’s Sale of Goods* (sixth edition), Sweet & Maxwell, London, 2002; *Consumer Sales Law* by John Macleod (second edition), Cavendish Publishing Limited, 2002.

2002 (the Regulations). The Regulations came into force on 31 March 2003 and significantly increase the rights of consumers. The Regulations implement Directive 1999/44/EC of the European Parliament and Council.

5.7. In this section we set out the most important provisions of the Sale of Goods Act relating to the quality of goods, so far as relevant to this inquiry, as well as noting the developments effected by the Regulations.

5.8. The most important provisions of the Sale of Goods Act are sections 13 and 14. Section 14(2) makes it a term of every sale in the course of a business that the goods supplied under the contract must be of satisfactory quality.

5.9. Section 14(3) provides that where goods are sold in the course of a business the goods must be reasonably fit for any particular purpose that was made known to the retailer (unless the circumstances show that the buyer does not rely, or that it not reasonable for the buyer to rely, on the skill or judgement of the seller).

5.10. Section 13 provides that where a contract is made for the sale of goods by description, the goods must correspond with the description.

### ***The requirement of satisfactory quality in section 14(2) of the Sale of Goods Act***

5.11. By section 14(2A), goods will be of satisfactory quality if they meet the standard a reasonable person would regard as satisfactory, taking account of any description of the goods, the price (if relevant) and all other relevant circumstances. The Sale of Goods Act provides some clarification as to the matters that may indicate whether goods are of satisfactory quality for the purposes of section 14(2A), and as to the factors that are part of the relevant circumstances. Starting with quality, section 14(2B) provides that 'the quality of goods includes their state and condition' and states that the following (among others) are, in appropriate cases, aspects of the quality of goods:

- (a) fitness for all the purposes for which goods of the kind in question are commonly supplied;
- (b) appearance and finish;
- (c) freedom from minor defects;
- (d) safety; and
- (e) durability.

As to the 'relevant circumstances', the Regulations have added a new section, section 14(2D) where goods are purchased by consumers. Public statements on the specific characteristics of the goods made about them by the seller, the producer or their representative, particularly in advertising or on labelling, are specifically stated to be matters that are part of the relevant circumstances.<sup>1</sup>

5.12. However, the requirement that goods be of satisfactory quality does not extend to any defect in goods if that defect is specifically drawn to the buyer's attention before the contract is made, or if the buyer has examined the goods and the examination ought to have revealed the defect, or if the contract is for a sale by sample and the defect would have been apparent on a reasonable examination of the sample.<sup>2</sup>

5.13. 'Durability' is an important aspect of the quality of goods. Goods must endure for a reasonable period of time in all the circumstances to be of satisfactory quality. However, notwithstanding that consumers have thereby a right to durable goods, it may be difficult for a consumer who wishes to rely on that to establish that the failure of goods is due to their lack of durability, and not due to their misuse or lack of maintenance. It is therefore significant that under section 48A(3) of the Sale of Goods Act the

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<sup>1</sup>But there are exceptions in section 14(2E), where, inter alia, the seller was not and could not reasonably have been aware of the statement, or where the decision to purchase could not have been influenced by the statement.

<sup>2</sup>Section 14(2C) Sale of Goods Act.

burden of proof that goods are, inter alia, not of satisfactory quality is reversed. Where it appears within the first six months after delivery of goods to the purchaser that the goods are not of satisfactory quality, it is for the vendor of the goods to establish that they were in fact of satisfactory quality.<sup>1</sup>

5.14. The terms implied by sections 13 and 14(2) and (3) are conditions of the contracts into which they are implied. Consequently, the starting point for any analysis of the consequences of breach of these provisions is that consumers are entitled to:

- (a) reject the goods and claim their money back, provided they have not accepted<sup>2</sup> the goods; or
- (b) claim compensation (typically the cost of repair or replacement).

5.15. However, the Regulations have supplemented the remedies available to the consumer. Consumers who buy goods in circumstances where at the time of delivery there is a breach of any of the implied terms<sup>3</sup> of sections 13 and 14 of the Sale of Goods Act<sup>4</sup> may require the vendor of the goods to repair or replace the goods. Thus, the primary remedy under the Sale of Goods Act, of damages, has been supplemented by a new remedy of repair or replacement. The Regulations have also imported 'secondary' remedies into the Sale of Goods Act, being a right to a reduction in the purchase price of goods, or a right to rescind the contract.<sup>5</sup> The repair or replacement is to be carried out within a reasonable time, without significant inconvenience to the purchaser, and at the expense of the vendor. There are limitations on the right to require repair or replacement. For example, where it would be disproportionate to require replacement in preference to repair, or repair in preference to replacement.

5.16. As to the availability or reduction in the purchase price or rescission, these are secondary to the right to repair or replacement in that they are only available if repair or replacement would be disproportionate by comparison, or if, the purchaser having requested the vendor to repair or replace the goods, the vendor has failed to do so within a reasonable time and without significant inconvenience to the buyer.

## **Consumer Credit Act 1974**

5.17. Section 75 of the Consumer Credit Act 1974 makes a person who finances a consumer purchase liable for any breach of contract or misrepresentation by the seller. This applies only to cases where the cash price is at least £100 but not more than £30,000.

5.18. The section applies to the ordinary tripartite arrangements between a retailer, a consumer and a finance house regarding a hire-purchase transaction and it applies to credit card transactions. Subject to any agreement to the contrary, the supplier of the finance has a right of indemnity against the retailer.

## **Guarantees**

5.19. The Regulations are relevant to our inquiry not just for the changes they make to the Sale of Goods Act. Prior to the Regulations, there was a good question as to whether a manufacturer's guarantee could be enforced by a consumer. This is because it is not clear that there is any contractual relationship between the consumer and the manufacturer. The Regulations remove this doubt by providing that consumer guarantees (as defined) take effect as contractual obligations owed by the guarantor 'under the

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<sup>1</sup>Although this reversal of the burden of proof is relevant only to the new, and very significant, remedies imported into the Sale of Goods Act by the Regulations. See paragraph 5.13 et seq.

<sup>2</sup>A buyer is treated as having accepted the goods if (among other things) the buyer has not rejected them after the lapse of a reasonable time. What is a reasonable time is a question of fact in each case. The buyer is also treated as having accepted them if the buyer does anything which is inconsistent with the ownership of the seller after the buyer has had a reasonable opportunity of examining them. The Act expressly provides, however, that the buyer is not to be treated as having accepted them merely because the buyer asks for, or agrees to, their repair by or under an arrangement with the seller.

<sup>3</sup>Or indeed a breach of any express term of a contract for the sale of goods.

<sup>4</sup>There is a rebuttable presumption of non-compliance if at any point in the six months after the purchase of the goods they do not conform to contract.

<sup>5</sup>It seems that the difference between this right to rescind and the right to reject goods stated in paragraph 5.13 is that the latter only applies where there has been a breach of a condition, including the conditions implied by sections 13 and 14, and before the right to reject goods is lost. The former applies to the breach of any express term of a contract, as well as to the implied conditions in sections 13 and 14, but is only available in the circumstances set out in the Sale of Goods Act.

conditions set out in the guarantee statement and the associated advertising'. There is also a provision requiring guarantors to set out the terms of the guarantee intelligibly in plain English, as well as 'the essential particulars necessary for making claims under the guarantee'.<sup>1</sup>

## **New EC law**

5.20. There are a number of recent EC directives, or proposals for directives, that have or may have an impact on at least some part of the supply of EWs.

5.21. The Consumer Protection (Distance Selling) Regulations 2000<sup>2</sup> implement Directive 97/7/EC on the protection of consumers in relation to distance contracts. A number of obligations are by these regulations imposed on vendors that engage in distance selling. For present purposes, most likely to be affected are those that sell EWs by catalogue, telephone or email. However, those EWs that are insurance appear to be excluded from the regulations. Among other things, the regulations impose obligations in relation to the disclosure of information pre- and post-contract, and create a right of cancellation in certain circumstances.

5.22. Directive 2002/65/EC concerning the distance selling of consumer financial services must be transposed into domestic law by 9 October 2004: the Treasury is consulting interested parties on its implementation, replies being required by 17 October. EWs that are insurance contracts may well fall within the provisions of this directive. Among other things, the directive imposes obligations in relation to the provision of information, and rights of withdrawal that may, to some extent, impose upper limits.

5.23. On 18 June 2003 the European Commission issued a proposal for a Directive on Unfair Commercial Practices. According to the European Commission<sup>3</sup> 'this Directive will ban unfair advertising, marketing and other commercial practices used by businesses in their dealings with consumers. In particular practices which are misleading or aggressive will be banned'. The purpose of the draft directive appears to be to protect consumers against practices that affect their decision-making.

5.24. The draft directive states at Article 5 that 'Unfair practices are prohibited'. Three classes of unfair practice are then identified. There is that behaviour that is unfair because it is 'contrary to the requirements of professional diligence' and which distorts the economic behaviour of consumers.<sup>4</sup> Second, there are misleading commercial practices. Third, there are aggressive commercial practices. Annex 1 of the draft directive sets out a list of practices that are always to be taken to be unfair. Further articles set out in more detail what will constitute misleading actions, misleading omissions, and aggressive commercial practices.

## **Insurance regulation**

5.25. Insured EWs as insured products are subject to the insurance regulatory regime. Service-backed EWs are supplied by companies not authorized to carry on insurance business, have not been treated as constituting contracts of insurance and are not subject to any other specific regulatory code. As discussed below, EWs have to be considered in respect of two broad areas. These are prudential or solvency regulation and the regulation of selling.

## **Carrying on insurance business**

5.26. Section 19 of the Financial Services and Marketing Act 2000 (the FSM Act) provides that, subject to exceptions, no person shall carry on any 'regulated activity' in the UK unless that person is an 'authorised person' within the meaning of the FSM Act. Effecting contracts of insurance as principal is a 'regulated activity'<sup>5</sup> and is accordingly regulated by the FSM Act. Authorized persons are (a) persons who have been granted permission by the FSA or its predecessors under earlier legislation; and (b) certain persons authorized by other European Economic Area (EEA) states. 'Person' in this context includes companies and partnerships.

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<sup>1</sup>Regulation 15 of the Regulations.

<sup>2</sup>SI 2000/2334.

<sup>3</sup>*Questions and answers on the proposed Unfair Commercial Practices Directive* (MEMO/03/135).

<sup>4</sup>Article 5.

<sup>5</sup>See the FSM Act (Regulated Activities) Order 2001 (SI 2001/544).

5.27. We refer to companies that have been granted permission by the FSA or its predecessors to effect insurance contracts as ‘authorized insurance companies’. A company authorized by another EEA state is regulated by the authorities of the other state. However, a series of directives ensure a substantial degree of harmonization.

5.28. Authorized insurance companies are covered by the FSCS established under section 213 of the FSM Act. The Scheme is a safety net for customers of financial services firms. It requires the scheme manager to pay compensation if an authorized firm is unable to pay claims against it. The Scheme is funded by the industry and covers deposits, insurance and investments. EC directives require other EEA states to operate similar schemes. For contracts of insurance entered into by consumers, the FSCS provides for eligible claims 100 per cent compensation on the first £2,000 and 90 per cent on amounts above this level: such claims include the unexpired portion of any premium under relevant contracts of general insurance.

5.29. Authorized insurance companies are subject to the prudential rules for insurers made by the FSA under section 138 of the FSM Act. The current rules are contained in the Interim Prudential Sourcebook for Insurers. They contain detailed requirements on such things as margins of solvency. They also contain the important provision that an insurance company must not carry on any commercial business other than insurance business and activities directly arising from such business. Companies authorized in another EEA state are subject to equivalent requirements. EC directives require other EEA states to operate similar schemes.

5.30. The question of when the provision of warranties needs authorization under the FSM Act gives rise to difficulties. In August 2002, the FSA issued a document CP 150 entitled ‘Consultation on Draft Guidance on the Identification of Contracts of Insurance’. It expresses the view that ‘simple’ warranties issued by retailers or manufacturers, where the purchase price of the goods includes an amount in return for which the manufacturer undertakes to rectify specified defects in the product that emerge within a defined time after purchase, are not contracts of insurance: as the warranty is a consequence of the obligation to provide goods that meet a required (often statutory) standard, the warranty does not involve a transfer of risk but a recognition and crystallization of an existing responsibility. However, where warranties are provided not as an inherent part of the purchase but as a separate transaction, usually with a separate consideration, then the FSA’s approach is to classify contracts of this kind as insurance if, in substance, in return for the customer’s payment, risk is transferred to the provider. This is so even if the warranty contract is agreed in the context of the sale of the goods. Whether risk is transferred will depend on the facts of the case. If the provider is a third party, this will, in the FSA’s view, usually be conclusive of the fact that there are different transactions and a transfer of risk.

5.31. At the time when we submitted this report to the Secretary of State, the FSA had not announced whether its draft guidance would be confirmed or modified. What constitutes a contract of insurance is ultimately a matter for the courts. The FSA has set out its view of the law in its guidance. If that view prevails, then given that well over half of the EWs supplied are treated by their providers as being ‘service-based’ warranties, ie not normally regarded as contracts of insurance, the results of the consultation could be significant for the consumers concerned. Although, as explained in Chapter 4, the suppliers of service-based warranties usually insure their liabilities to customers with captive insurers owned by major retail groups that act as agents for the suppliers in providing their warranties, the captive insurers are mostly in jurisdictions where there is no equivalent of the FSCS, however rigorous the prudential standards of the insurance regulatory regime may be. Identification of a material number of service-based warranties as meeting the criteria for being treated as contracts of insurance and thus having to be brought within the perimeter of UK insurance regulation could, therefore, lead to an increase in the protection available to consumers.

5.32. Although statutory reform of insurance contract law has been recommended on occasions and contracts of insurance are subject to aspects of the general law such as the Unfair Terms in Consumer Contracts Regulations 1999, there has traditionally in the UK been no regulatory control of the terms and conditions of insurance policies. The insurance industry introduced in 1977 and revised in 1986 self-regulatory Statements of General Insurance Practice and of Long-Term Insurance Practice: under these, most insurers undertake, in effect, not to exercise some of their legal rights against consumer policyholders—for example, under the Statement of General Insurance Practice, an insurer will not

repudiate liability to indemnify a policy-holder on grounds of non-disclosure of a material fact which he could not reasonably be expected to have disclosed, or on grounds of misrepresentation unless it is a deliberate or negligent misrepresentation of a material fact.

5.33. The Statements of Practice have been complemented by the development of conciliation machinery for disputes between insurers and policy-holders. This began with the setting up (and financing) by the insurance industry in 1981 of the Insurance Ombudsman Bureau (IOB). The IOB's role has now been subsumed, with those of other sectoral ombudsman schemes, within the statutory Financial FOS under Part XV of the FSM Act, in respect of persons and activities subject to it. The Ombudsman News published by the FOS in January 2001 noted that at that time some 10 per cent of the complaints referred to the Insurance Division of the FOS concerned EWs and that EW policy-holders frequently misunderstood their policies, for example that most were narrower in scope than they had realized or that some policies had complex procedural requirements to be followed in order to make valid claims.

5.34. An important example of these procedural requirements illustrated in case studies published by the Insurance Division of the FOS at the same time concerned cashback schemes marketed by certain providers of EWs for electrical goods. Under these, at the expiry of an EW, usually for five years, the warranty holder was entitled to have their premium reimbursed if there had been no claim made on it. To qualify for cashback, the policy-holder had to adhere to certain administrative procedures such as registering with the insurer within a stipulated period after entering into the contract or remembering to claim the cashback refund no later than, say, one month after the policy expired. Some policy-holders failed to meet the procedural requirements applying and took their disputes to the Ombudsman. In at least one case, he found that failure to meet the insurer's procedural requirements was not sufficient ground for rejecting a claim and made a finding requiring the insurer both to meet a cashback claim and compensate the policy-holder for costs in pursuing her complaint. Since then, most of the companies offering cashback have withdrawn this element of cover, though it remains in place for existing policies issued by them until these expire.

5.35. Consumer surveys published by, for example, the OFT have shown that many consumers are unaware of the distinction between insured and service-backed EWs. The compulsory jurisdiction of the FOS relates to parties authorized to carry on activities regulated by the FSM Act and the providers of service-based schemes have not submitted themselves to the voluntary jurisdiction of the FOS. In consequence, the degree of consumer protection available to buyers of them is different and, in certain respects, less than it would otherwise be. However, as described in Chapter 4, in many service-backed (ie uninsured) EWs a small part of the charge to the consumer is used to buy an element of insured cover such as for frozen food loss or theft, as these risks are more suited to the policy-holder being indemnified through a payment, as for many insured risks, than they are by the provision of a physical service like repair. Insured cover of this kind is generally the subject of a separate policy from the main repair element of the warranty. So to that extent, the FOS may in practice have some jurisdiction in relation to part of the warranty market. But the main part of such contracts, the 'service' component, would seem to remain outside that jurisdiction.

## **Conduct of business rules**

### ***Introduction***

5.36. Rules on the selling ('conduct of business') of most types of life insurance have been subject to statutorily-based regulation since the enactment of the Financial Services Act 1986. This is not the case in respect of other types of insurance, including insured EWs, where self-regulation applies under codes drawn up and implemented by the GISC and the ABI. This position is to change when FSA regulation of the selling of general insurance is introduced with effect from 14 January 2005. However, as described in paragraph 5.43, the treatment of insured EWs on DEGs within the new regulation remains to be determined.

### ***The General Insurance Standards Council Code***

5.37. GISC is an independent, non-statutory organization which was launched in July 2000 by its members to regulate their sales, advice and service standards, for the purpose of ensuring fair treatment

of general insurance customers. GISC members may be insurers or intermediaries, or other bodies involved in general insurance such as claims handlers. As at October 2002, GISC had some 6,500 member businesses. GISC's activities cover consumers and business customers for general insurance, including extended warranties. The GISC Private Customer Code sets standards of good practice to be followed by GISC members: among areas covered are helping consumers to find insurance meeting their needs; provision of information on services and products offered and on costs; only advising on matters which those advising have knowledge of; provision of a 'cooling-off' period of 14 days in which the customer can cancel a policy and receive the premium back; and the provision of full cover documentation.

5.38. The GISC Code applies to contracts of insurance but not service-backed EWs. It is binding on GISC members, who do not include the major retailers offering EWs. However, some of these act as agents of insurers who are GISC members and to that extent GISC standards can apply to at least some of their EW activity.

### ***The Association of British Insurers Code***

5.39. ABI is a trade association with some 400 insurance companies accounting for over 90 per cent of UK insurance companies' business. Since 1989 it has operated a General Business Code of Practice, with the purpose of ensuring that consumers are clear about the terms of an insurance policy and the status of the intermediary (ie broker or agent) with whom they deal—for example, whether the intermediary is owned or controlled by a particular insurer. The Code provides a framework of principles within which member companies should supply insurance, though the interpretation of its requirements varies according to the particular type of insurance and the circumstances of the customer. In its practical operation, the intermediary or the direct seller should provide the consumer with an overview of the policy and reasonable information to understand the cover, either orally or in written summary form, including the relationship of the intermediary to the insurer, such as acting as agent for a particular company or acting as an independent intermediary. The emphasis is on identifying as far as possible the level of cover needed to ensure that the type of policy being sold meets the needs of the buyer and that, in addition, he understands any restrictions or exclusions in the policy. The Code also provides information on the handling of claims and on any complaints that the customer may have. Independent intermediaries are required to have professional indemnity cover to conform with the Code.

5.40. ABI members, rather than intermediaries, are responsible for enforcing the Code. Thus an ABI member would take responsibility for ensuring that, say, an electrical retailer offering insured EWs met the Code standards. As with the GISC Code, the ABI Code would not appear to apply to service-backed EWs entered into by an intermediary except in so far as it is bundled with a separate insurance contract for part of the total cover under the warranty.

### ***FSA regulation***

5.41. On 12 December 2001, the Treasury announced that the selling of general insurance would be brought within statutory regulation under the FSA from 14 January 2005. The announcement took account, in particular, of the then impending adoption of the IMD. The IMD includes requirements for registration of intermediaries; the possession of appropriate knowledge and ability by intermediaries; minimum financial capacity, including a guarantee fund; client money to be held in segregated client accounts sheltered from other creditors; and professional indemnity insurance to be held by intermediaries.

5.42. The IMD does not apply to persons providing mediation services (ie acting as intermediaries) for contracts of insurance if all of a number of conditions are met, including that the principal professional activity of those persons is other than insurance mediation; the insurance is complementary to the product or service supplied by any provider and covers risk of breakdown, loss of or damage to goods supplied by that provider; the amount of the annual premium does not exceed €500; and the total duration of the insurance contract, including any renewals, does not exceed five years. The effect of these provisions would be to exclude most insured EWs offered by providers at POS.

5.43. It is open to member states to implement the IMD more extensively than the above provisions permit. The Treasury has stated that insured EWs for mechanical breakdown by motor vehicles will be

subject to the FSA rules, even though these warranties could also have been excluded by reference to the IMD criteria set out in paragraph 5.43: travel insurance sold as part of a package will not be subject to them. However, the Treasury has announced that it will await the publication of our report before deciding whether to bring EWs for DEGs within the FSA rules.

5.44. The consultation on identification of contracts of insurance referred to in paragraphs 5.30 and 5.31 could lead to substantial numbers of service-based EWs falling within the FSA's regulatory perimeter as insurance business. That might increase the likelihood of EWs being brought by the Treasury under the FSA selling rules. Identification of service-based warranties as contracts of insurance should itself increase the protection available to consumers. But inclusion of EWs within the selling rules would have the advantage of further increasing consumer protection through the regulation of intermediaries. This would be so even if the EWs themselves, having been identified as contracts of insurance, were supplied by non-EC insurers without an establishment in the UK. In that event, the question would arise whether a non-EEA insurer was in fact carrying on insurance business in the UK and thus subject to regulation under the Act: for that, the main criterion would be where the principal underwriting decisions were taken. As contracts of insurance entered into by a party not authorized by the FSA are not normally enforceable against the customer, it might be considered that no prudent intermediary would offer contracts underwritten by a non-EEA insurer without being sure that the Act was not being breached.

5.45. The FSA rules will also implement other parts of EC law, which may include some of the Directive on the Distance Marketing of Consumer Financial Services (2002/65/EC). That directive does not appear to give rise to any additional issues of substance although, as noted in paragraph 5.22, particular points may arise in connection with limits set in it.

## **Taxation and extended warranties**

### ***Introduction***

5.46. The extended warranties market is affected by three main taxes each of which has its own jurisdictional boundary. Corporation tax is paid by UK companies on their worldwide profits to the extent that these profits are not subject to tax in another jurisdiction. IPT is levied at different rates on different types of insurance policies but is payable on all policies sold in the UK. VAT is payable on taxable supplies of goods and services in the UK and Isle of Man and may be offset against VAT arising on purchases. The impact of each of these taxes on the EW market is examined below.

### ***Direct taxes***

#### ***Use of offshore and captive insurance company arrangements***

5.47. Under corporation tax self-assessment (CTSA), UK companies must declare all controlled foreign companies (CFCs)<sup>1</sup> in which they have an interest and self-assess the corporation tax due on their eligible profits.<sup>2</sup>

5.48. A company is deemed to have an interest in a CFC if:

- it holds a 25 per cent interest in the company; and
- the company has a minimum profit of £50,000.

5.49. Where a UK resident company has an interest in a CFC, the profits of the CFC are taxed in the UK to the extent that they *would have been* assessable to UK tax if the CFC had been a UK resident

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<sup>1</sup>A CFC is a company that is:  
— resident outside the UK;  
— controlled by persons resident in the UK; and  
— is subject to a lower level of tax in the country in which it is resident (lower than the rate at which it would be taxed in the UK—small company rate, 20 per cent, medium-sized company at marginal rate of approx 35 per cent or large company rate, 30 per cent).

<sup>2</sup>Eligible profits are those profits arising from activities which do not fall within the list of exempt activities (as detailed below).

company (subject to any eligible double tax relief). That is, the profits which would have been assessable to tax are included within the corporation tax computation of the UK parent and the amount of tax already paid in the territory in which the CFC is resident is deducted from the balance due to avoid any double taxation on the same profits.

5.50. Under current legislation certain activities of CFCs are deemed to be ‘exempt activities’. The relevant conditions are summarized immediately below; the references are to terms used within the Income and Corporation Taxes Act 1988 (ICTA88).

5.51. Condition 1(b)—Exempt Activities—states that a CFC is engaged in exempt activities if, throughout the accounting period it has a business establishment in the territory in which it is resident, its business affairs are ‘effectively managed’ there; and, in the case of companies mainly engaged in the period in wholesale distributive or financial business, less than 50 per cent of the gross trading receipts from that business are derived either directly or indirectly from connected or associated persons.

5.52. By taking advantage of the exemption in the CFC legislation prior to 27 November 2002, some retailing groups developed structures which enabled them to retain substantially all the risks and rewards of selling EW policies in the UK without becoming eligible to pay UK corporation tax on the profits arising from these policies.

5.53. To achieve this, certain EW schemes have been structured such that EW customers contract directly with an unconnected third party insurance company rather than with the retailer from whom they purchase the DEG. This third party insurer then reinsures the EW policies with the retailer’s offshore captive insurance company thus shifting the risks and rewards of the policy back to the retailer’s group. Where the retailer has chosen to provide a service-backed EW scheme, the EW customer contracts with an unconnected third party service company (generally a member of an insurance group). This service company then insures its risks with the retailer’s offshore captive. By ensuring that the EW contract is held between the customer and a third party, the offshore captive is able to demonstrate that less than 50 per cent of its income is derived from connected or associated parties and thus satisfy Condition 1(b)—Exempt Activities—as set out in paragraph 5.51.

5.54. Profits arising from exempt activities thus fall outside the scope of UK corporation tax notwithstanding the fact that, had the company been UK resident, it would have been assessable to corporation tax on those same profits.

#### *Legislation with effect from 27 November 2002*

5.55. The legislative changes announced in the pre-budget report of 27 November 2002 were aimed at taxing the profits that arise on the EW businesses of UK retailers/retailer’s groups that have captive insurance companies resident in overseas jurisdiction. Where the captive insurance company receives insurance or reinsurance premiums directly from unconnected parties rather than other group companies, the changes to the CFC legislation now bring the profits arising from this activity into the charge to UK corporation tax, that is, they no longer qualify as exempt activities. These changes apply only to accounting periods beginning on or after 27 November 2002.

5.56. The additional corporation tax due as a result of this change will become payable in the UK by the parent company of the CFC and will be the difference between the amount which would have been payable in the UK had the captive been a UK resident company and the amount which has already been paid in the jurisdiction in which it is currently resident (thus avoiding any double taxation on the same profits). The changes to the legislation will substantially reduce the tax effectiveness of structures such as those set up by Dixons, the former ARG Equation (now Shop Direct UK Ltd), Apollo, Miller Brothers, Otto and USP Strategies (Pinnacle) for Littlewoods, Powerhouse, John Lewis and GUS (see Chapter 7—Pinnacle/USP Strategies).

5.57. The legislative changes will also affect the insured EW schemes where the unconnected primary insurer reinsures with a retailer’s offshore captive. The profits arising in the offshore captive will now be taxable in the UK.

5.58. These structures do, however, generate indirect tax benefits described in the following sections and these are not affected by the changes in CFC legislation.

### ***Indirect taxes***

5.59. When EWs were first introduced they were in the form of non-insured contracts for the consumer. However, over the years as indirect tax legislation changed it became advantageous for providers of EWs to move away from non-insured to insured contracts which attracted IPT at a lower rate than the VAT levied on non-insured products despite no input VAT offset.

### ***IPT***

5.60. IPT is levied on insurance premiums payable in the UK.

5.61. IPT on certain general insurance contracts, including insured EWs, was introduced in 1994 and was levied on all insured EW premiums at the general rate of 2.5 per cent. Before that date no IPT was levied on insured EW contracts. In 1997, the rate for insured EW policies sold by anyone selling a DEG at the same time was increased to 17.5 per cent (to match the rate of VAT) and to 4 per cent for general insurers (who do not sell DEGs at the same time). Unlike VAT, IPT is not recoverable under any circumstances and this led to many retailers moving away from offering insurance-backed EW schemes at the POS to offering service-backed schemes which are subject to VAT (see below).

5.62. The general IPT rate, 4 per cent, was increased to 5 per cent in 1999 for policies sold directly by insurance companies to consumers. Free EWs attract IPT at 5 per cent which is payable by the agent (often a retailer, manufacturer and credit card companies) who provides the EW free of charge to the consumer. Insured EWs for mobile phones and fax machines attract IPT at 5 per cent regardless of how they are sold.

### ***VAT***

5.63. VAT is levied on the supply of goods and services in the UK or Isle of Man. All companies (regardless of place of residence) making taxable supplies of goods and/or services in the UK must register for VAT if the total value of their sales is expected to exceed the registration threshold.<sup>1</sup> Input VAT is only recoverable by VAT registered companies.

5.64. As noted, service-backed EWs are not insurance products and therefore attract standard rate VAT of 17.5 per cent. Companies that supply these contracts can recover the input VAT incurred on their purchases (such as external repair costs) against output VAT levied on the EW at the POS and a net figure paid to/recovered from HM Customs and Excise. Insurance companies may register for VAT under certain circumstances but they would never be entitled to recover input VAT incurred on repairs to DEGs under warranty since insurance is classified as an exempt activity for VAT purposes and therefore any VAT which arises in relation to it may not be offset against any output VAT arising on other activities conducted by the company. Hence the VAT benefit, and hence the move to service-based contracts since 1999.

### ***Offshore locations***

5.65. Most of the offshore captive insurance companies involved in the EW business have been located in one of a number of offshore jurisdictions: Isle of Man, Guernsey or the Dutch Antilles. The benefits of these locations arise from the different boundaries which exist for each of the taxes discussed above. These are:

- (a) Prior to 27 November 2002, companies based in these jurisdictions were able to meet the conditions to qualify as CFCs and thus benefit from tax advantages not available to companies located in the UK carrying out the same business.

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<sup>1</sup>A company would be required to register for VAT if its taxable supplies have or are expected to exceed the registration threshold which, in the 12 months beginning on 25 April 2002, is £55,000.

- (b) UK IPT is levied only on insurance premiums which arise in the UK. In many of the schemes we have seen, the EW consumer contracts with an offshore service company which then insures its risk with an offshore captive insurance company. Since both of these companies are based offshore no IPT arises on the insurance transaction.
- (c) Any offshore company which makes taxable supplies in the UK may choose to register for UK VAT. By opting to register for VAT in the UK, offshore service companies are able to offset input VAT incurred on repairs against VAT levied on the sale of the EW policies. The Isle of Man has a bilateral agreement with HM Customs and Excise whereby VAT arising there automatically falls within the UK VAT jurisdiction and is treated as though it arose in the UK. Companies based in other jurisdictions must specifically register for UK VAT to gain this benefit.

## **Self-regulation**

### ***British Retail Consortium Best Practice Code***

5.66. Although most of the regulation described in this chapter is laid down or derives from statutory provisions, paragraphs 5.32 and 5.37 to 5.40 summarize a number of self-regulatory codes under the auspices of the ABI and the GISC. Also relevant is the BRC Best Practice Code on Extended Warranties on Electrical Goods. The full text of the BRC code is contained in Appendix 5.1. The BRC is the main trade association for the retail sector: all the major retail providers of EWs are among its members. The BRC code was introduced in 1995 and later modified. The code sets out provisions which:

- (a) make information available at the POS on the prices, terms and conditions, whether insured and if so by who, cancellation period and accompanying terms;
- (b) lay down certain standards to be met such as avoiding false or misleading statements, undue pressure to buy EWs at POS, only offering warranties that provide additional coverage where the product carries a free manufacturer guarantee, providing contract documentation;
- (c) observe standards of financial protection such as insured contracts to be directly between the customer and the insurer, only insurers authorized to carry out insurance business in the EC to be used, service-backed EWs to be covered by ring-fenced funds; and
- (d) require audit of systems and compliance with the code, recording of complaints and annual reporting on compliance to the BRC.

5.67. As mentioned in paragraph 3.8, the OFT's view that the BRC code was not being fully complied with by retailers was one of the reasons for the reference.