

EXPLANATORY NOTE

CLAUSE 169 AND SCHEDULE 33: INSURANCE COMPANIES

SUMMARY

1. The clause and Schedule make a number of changes to the taxation of companies carrying on life assurance business in order to prevent avoidance, close loopholes and deal with other anomalies. They affect the treatment of chargeable gains, of Case I profits and of business transfers.

DETAILS OF THE CLAUSE

2. Clause 169 is a paving clause for Schedule 33.

DETAILS OF THE SCHEDULE

3. The Schedule sets out the operative legislation.

Paragraph 1: policy holders' bonuses, tax etc.

Background - new sections 82, 82A and 82B

4. Section 82 was introduced as part of the major reforms of life assurance taxation in 1989 and 1990. Norman Lamont, then Financial Secretary to the Treasury, described the purpose of the legislation. He said—

“The object is to ensure that there is proper matching between the deductible bonus allocations and liabilities to policy holders, on the one hand, and the incomings which fund those liabilities on the other.....The main effect of the clause is to ensure that taxable incomings and deductible liabilities follow the figures in offices' own accounts, thus ensuring internal consistency and a proper balance between credits and debits”.

Hansard: Standing Committee G cols 368/9 8 June 1989.

5. Section 82 replaced a rule which had come to be known as the “reservations” rule, latterly found in section 433 Income and

Corporation Taxes Act 1988 (“ICTA”), but dating back to section 53 Finance Act (“FA”) 1920 applying to the long obsolete Corporation Profits Tax. Despite its antiquity and brevity, there had never been any wholly satisfactory agreement about what it meant. Section 82 put it beyond doubt that there were only two items which could be deducted in a computation of profits of a company carrying on life assurance business that is made under the provisions of Case I of Schedule D that arguably were not permitted by those provisions. The two matters were tax and bonuses.

6. Bonuses payable to policy holders in cash or as reductions of premiums were a common feature of life assurance in the 19th century. In time reversionary bonuses, declared at the end of a year but payable only on termination (by death, maturity and sometimes surrender) of the policy became the overwhelming norm, and in the second half of the 20th century terminal bonuses, paid on termination at the discretion of the company, began to be common usually payable out of investment growth that companies experienced as they invested more in equities.

7. A case heard by the House of Lords in 1885, *Last v London Assurance Corporation* (2 Tax Cases 100), showed that cash bonuses, premium reductions and amounts added to sums assured (reversionary bonuses) were not a deduction in computing profits for the purposes of Case I of Schedule D. But Section 433 and its predecessors did permit allocations of profit to policy holders to reduce profits. Section 82 continued this and made it explicit that a deduction was due in a Case I profit computation, in the case of reversionary bonuses by adding the present value of them to the closing figure of liabilities. It was thus implicit from this that the starting point for a Case I computation of life assurance business was the figure of surplus for the year after distribution of surplus to policy holders.

8. Section 433 also permitted amounts reserved for policy holders to reduce profits, as well as amounts allocated as bonuses. This concept was generally removed from tax legislation, but a remnant remains in the shape of section 82(1)(b), (3) and (4) FA 1989. This allowed a company which had an unappropriated surplus to add to its closing liabilities an amount (so long as it exceeds all previous reservations under section 433 and its predecessors) that was shown to be necessary to meet the reasonable expectations of policy holders with regard to bonuses. The relief is designed to accommodate a very small number of companies which wrote with-profits business, but which did not take

advantage of the ability of a company to elect to use the book value of assets if lower than their market value in arriving at the surplus of a period. The use of a book value election to build up an “estate” to enable a company to satisfy with-profits policy holders’ reasonable expectations (or what is now the requirement in the Principles of the Financial Services Authority’s (“FSA”) Handbook that policy holders be treated fairly) is commonplace in insurance in the UK. method - see paragraph 303 onwards.

9. Section 82(1)(a) also allowed a deduction for tax expended on behalf of policyholders. Given that tax is charged on the income which will go to policy holders when their policies pay out (and is reflected in the basic rate credit given by section 547 ICTA), it should be as much an allowable deduction in computing a profit under Case I rules as claims paid and liabilities assumed to policy holders. If the issue were being approached anew, in the light of section 42 FA 1998, it is likely that the deduction for policy holders’ tax would be taken for granted, there being no obvious rule of tax law to prevent it.

10. Matters were not so clear cut in 1920 however when a new tax was being enacted, and a provision was brought in then which allowed amounts expended on behalf of policy holders to reduce profits. Although tax was not mentioned, there is no doubt that tax, and only tax, was what the rule was aimed at, and this was finally made explicit in section 82 FA 1989 when enacted.

11. Nothing in section 82 as enacted explained though what was meant by the amount of tax expended on behalf of policy holders. It has not proved easy to reach agreement about what it does mean. Various methods are used from simply grossing up the Case I profit at the ruling rate of mainstream CT to the employment of various formulae.

12. Paragraph 1 of Schedule 33 rewrites and unpacks section 82 as a new section 82 (dealing with bonuses), section 82A (dealing with tax) and section 82B (dealing with the matters discussed in paragraph 8). The language and approach of the sections is modernised.

Detail - new section 82

13. Paragraph 1(1) substitutes a new section 82 for the existing one.

14. Section 82(1) provides the case for itself and the new sections 82A and 82B (see below) and reproduces the effect of the previous section

82(1), that it applies where a computation of a company's life assurance profits are made in accordance with the Case I provisions. Such a computation is made for a number of purposes (see paragraph 308)

15. Section 82(2) makes amounts allocated to policy holders or annuitants allowable deductions in a Case I computation. The wording of the relief is updated to follow the style of the Tax Law Rewrite and other recent tax provisions. The subsection replaces the previous section 82(1)(a), except in relation to tax (see section 82A below)

16. Section 82(3) defines what is meant by "allocated" in a variety of circumstances:-

- Cash (including terminal) bonuses are allocated if payments are made – paragraph (a)
- Reversionary bonuses are allocated if declared – paragraph (b)
- Reductions in premiums are allocated if a reduction is made – paragraph (c)

and not otherwise, so a provision for a bonus made before declaration, payment or reduction is not allowable as a deduction (following *Last's* case)

17. This subsection replaces the opening words, and paragraphs (a) and (b), of the previous section 82(2).

18. Section 82(4) explains what is the amount of the allocation that may be allowed as a deduction. In the case of payments of cash bonuses it is the amount of the payment. In other cases it is the amount of liabilities (known as mathematical reserves) assumed as a result of the declaration or reduction. This is the amount that appears in the periodical return made by insurance companies to the FSA (the "FSA return") on Forms 58 and 60. This subsection replaces the fullout words of the previous section 82(2).

19. As a result of the replacement of section 82, the complex transitional rules in section 82(5) to (8) which applied to a period straddling 13th March 1989 disappear.

Detail: new section 82A

20. The background to this section is described in paragraph 9.
21. Section 82A is also inserted by paragraph 1(1). This provides that a deduction is allowed for tax expended on behalf of policy holders. The need for such a rule derives from the method used in the UK to charge to tax income and gains accruing to a company carrying on life assurance business for the benefit of policy holders under the so-called I minus E
22. Section 82A(1) sets out the operative rule. This subsection replaces the previous section 82(1)(a) FA 1989 so far as it related to tax. Tax (which means UK corporation tax together with any vestigial amounts of income tax deducted at source and not repaid, or set off under Schedule 16 ICTA, but not foreign tax) expended on behalf of policy holders or annuitants is allowed as a deduction. The words “in respect of a period of account” previously appearing in section 82 have been removed. Before this change, tax which related to future (or past) periods was not deductible by virtue of section 82. But the Inland Revenue permitted a deduction for certain provisions for future policy holders’ tax – the basis for which was that there was no rule prohibiting it. The omission of the words ensures that an increase in a provision for future tax is deductible if it relates to policy holders’ tax, and equally a reduction in such a provision is taxable as a receipt. But the deduction for policy holder tax is qualified now so that only the amount as determined by regulations is so allowable.
23. Section 82A(2) is an extension of the existing rule, and is connected with the new section 83(2B) FA 1989 (see notes on paragraph 2 of Schedule 33). It is the practice of some companies not to charge certain amounts of tax, particularly tax relating to gains on assets, in its revenue account (Form 40 of the FSA return). Such tax does not fall to be deducted under the previous section 82. But with the enactment of section 83(2B) bringing all tax not so charged into account as a receipt, it is only fair to allow as a deduction the policy holders’ tax thus brought into charge. The regulations will provide how the amounts are to be determined, thus bringing to an end the disputes and differences in practice about tax.
24. Section 82A(3) is a boilerplate provision allowing the regulations to make different rules for different cases and to have effect for periods in which they are made. This is necessary because section 82A will only come into force on Royal Assent to the Finance Act 2003, and until it does, no regulations can be made. When made they will have effect

for the same periods as the new section 82A and paragraph 1 of Schedule 33 generally. It is intended that the regulations to be made, following consultation, will be definitive: but if this is not possible, “stopgap” regulations will be laid preserving the 2002 status quo.

Detail - new section 82B.

25. The background to this section is described in paragraph 8.

26. Section 82B(1) gives the case. It is where a company has at the end of the period of account an unappropriated surplus on valuation as shown in its FSA return – section 82B(1)(a). This surplus will be that shown on Form 58 at line 49. But the section only applies if the company has not made an election under Rule 4.1(6) of the Interim Prudential Sourcebook (Insurers) (“IPRU(INS)”) (previously regulation 45(6) of the Insurance Companies Regulations 1994) to value its assets at the amount it chooses (not being in aggregate greater than the admissible market value of the assets) – section 82B(1)(b).

27. Section 82B(2) and (3) are the operative rules. If there was no unappropriated surplus as at the end of the previous period (because, for example, the company is newly set up), a deduction is allowed for the amount of the surplus mentioned in section 82B(1)(a) as at the end of the period as is required to meet the company’s duty of fairness - section 82B(2). The “duty of fairness” is defined in section 82B(5) to mean the company’s duty to treat its policy holders and annuitants fairly with regard to terminal bonuses. This concept of fairness is one of the FSA’s Principles for Business, found in PRIN 2.1 of the FSA’s Prudential Sourcebook. This replaced the concept of “policy holders’ reasonable expectations” that was used in the Insurance Companies Act 1982 (“ICA”), repealed by the Financial Services and Markets Act 2000 (“FSMA”).

28. If there was an unappropriated surplus at the end of the previous period, and the amount of the surplus as at the end of the period in question that is required to meet the duty of fairness is greater than the corresponding amount at the end of the previous period, the excess is allowed as a deduction in computing Case I profits - section 82B(3)(a). Conversely if the relevant amount at the end of the previous period is bigger than the amount at the end of the period in question, the excess is treated as a Case I trading receipt - section 82B(3)(b).

29. Section 82B(4) reproduces the limitation previously in section 82(3). Any amount found as in section 82B(2) or (3) is reduced by the amount of any reservations made under section 433 (or its predecessor sections back to 1923) for periods ending before 13th March 1989 and the “first component period” of the straddling period covering 13th March, which ended on 13th March, so far as not allocated to policy holders or “dereserved” before 14th March 1989.

30. Paragraph 1(2) makes a consequential amendment in section 83A FA 1989 (meaning of “brought into account”) to refer to section 82A which also uses that term.

31. Paragraph 1(3) and (4) makes consequential amendments in sections 436 (charge to tax in respect of pension & individual savings account (“ISA”) business), 439B ICTA (charge to tax in respect of life reinsurance business) and 441 ICTA (charged to tax in respect of overseas life assurance business). They ensure that section 82 and all the provisions from section 82B to 83AB apply, to the computations of the Case VI profits of those categories of business in the same way (but with necessary modifications) as they apply in a Case I computation. Section 82A (policy holder tax) does not apply, as there is no policy holder tax in these categories.

32. Paragraph 1(5) gives the general commencement rule for paragraph 1 of Schedule 33. The new section 82 and sections 82A and 82B will apply to periods of account beginning on or after 1 January 2003. More than 90% of companies carrying on life assurance business have calendar year periods of account and financial years for regulatory purposes.

33. Paragraph 1(6) ensures continuity between the old section 82(1)(b) and the new section 82B. The unappropriated surplus for the immediately preceding period, a figure which it is necessary to compare, under section 82B, with the surplus for the period in question, is taken to be the amount found by old section 82(1)(b) where the period in question is the first one to begin on or after 1 January 2003.

Paragraph 2: Case I profits etc. receipts to be taken into account

Background

34. Section 83 was the other pillar in the special measures of computation of Case I profit of life assurance introduced in the

1989/1990 reforms. It was designed to equate the investment return brought into account in that computation with the amounts shown as investment return in the then “DTI return”, now the FSA return - see the quotation from Hansard in paragraph 4. But its interpretation has not been free from doubt, and challenges are being made to the Revenue’s interpretation which if successful could have a very serious exchequer effect. Paragraph 2 of Schedule 33 therefore puts the interpretation of section 83, and subsection (2) in particular, beyond argument. It also deals with attempts to side-step section 83(2) by not reflecting in the revenue account amounts which would normally fall to be so reflected, such as tax which would normally appear in the revenue account at Form 40 line 24 in the FSA return.

35. The revisions to section 83 also deals with extractions of profit from a company which are not reflected in a computations of profits drawing on entries in the revenue account. This needs further explanation.

36. The rules for computing Case I profits for life insurance companies are unique in a number of ways, most particularly their treatment of gains on the appreciation and realisation of investment assets. The Case I profits of life companies are also based on the surplus shown in the company’s FSA return so that the company’s solvency position can be monitored. This contrasts with the position for other trading companies which have their Case I profits based on their statutory accounts drawn up in accordance with the Companies Act 1985 - see section 42(1) and (5) FA 1998.

37. In the case of many life companies, an election may be made under Rule 4.1(6) of the Interim Prudential Sourcebook Insurers (“IPRU (INS)” (previously regulation 45(6) Insurance Companies Regulations 1994) to use book value rather than market value in determining surplus. Paragraphs 308 to 314 describe how that mechanism is used to defer recognition of value changes in assets and explain that companies have a substantial discretion as to how much is included in the entry in line 13 of Form 40, so long as it contains a large enough amount to enable a company to declare and pay bonuses and where relevant to transfer sums of surplus to be available for distribution to shareholders in the amounts it wishes to show.

38. It follows that if amounts are brought into account in the revenue account but are not taken into account for tax purposes, they “fill the hole” in the computation of surplus that could, in circumstances where

the excess of market value over book value (Form 14 of the periodical return at line 51) is sufficient, be filled by an entry in line 13 of Form 40 which would be a trading receipt by virtue of section 83(2).

39. Other ways of avoiding an entry in line 13 of Form 40 include charging amounts of expenditure such as tax otherwise than in the revenue account. If they had been reflected in that account, that would have reduced surplus so as to require a compensating additional amount in Form 40 line 13. By not being reflected in the revenue account, the line 13 amount required to balance the revenue account is *pro tanto* smaller, and if the expenditure is not deductible on normal Case I principles this manoeuvre effectively allows a deduction.

40. Section 83(3) to (8) of FA 1989, together with sections 83AA and 83AB, ensure that a company cannot generate an artificial tax loss where money is added to its long-term insurance fund (“L-TIF”), the fund into which all the premiums and investment return are entered, otherwise than in taxable form. But they only apply where the addition is made in connection with a court approved transfer of long-term insurance business or a “total reinsurance”, a transfer of a portfolio of policies by means of a reinsurance contract. These rules are amended, in particular to remove a feature of them that has turned out not to be needed.

Detail

41. Paragraph 2(1) is introductory.

42. Paragraph 2(2) replaces section 83(2) FA 1989 with five new subsections.

43. Section 83(2) – new version – is similar to the previous version. But the reordering of the opening words, taken with the fullout words of section 83(2A), makes it clear that what is taken into account as trading receipts (or expenses if negative) are the amounts contained in lines 12 to 15 of Form 40. Those lines are the lines whose description is set out in paragraphs (a) to (d) of section 83(2). They include explicitly now for the first time line 15 (“other income”). But even these are not exhaustive – if amounts meeting the descriptions are included in other lines of Form 40 they too are taxable by virtue of section 83(2).

44. Section 83(2A) sets out the only exclusions permitted from the effects of section 83(2):

- one is notional amounts such as credits for notional rents. Some companies which hold their own offices as assets of their L-TIF credit a “rent” in line 12 of Form 40 and make a corresponding deduction in line 22 (expenses). These credits are not taken into account; nor are the expenses.
- another is amounts falling within section 444AC(2) ICTA – see notes on paragraph 18(1) of Schedule 33 below.
- the final amount is any interest on repayments of tax or payments of tax credits that is exempt from tax (i.e. amounts in respect of pre-CTSA liabilities)

45. The fullout words reinforce the message in section 83(2) that there are no other exclusions irrespective of any exemption or relief from tax that might be given by other provisions of the Tax Acts.

46. Section 83(2B) brings into account as amounts within section 83(2) payments of cash, and the fair value of assets transferred, which are not reflected in the revenue account in the lines of Form 40 relating to expenditure – lines 21 to 26. The amounts concerned are, as in section 83(3), treated as brought into account as increases in value. There are exclusions from this rule in section 83(2C) and (2D) and in section 444AD ICTA (see notes on paragraph 18 of Schedule 33 below).

47. A definition of “fair value” (a term used in section 83(2B), (2D) and (4)(c)) is added into section 83(8) by paragraph 2(8) and has the normal accountancy meaning such as that given in Chapter 2 Part 4 FA 1996 (loan relationships) and Schedule 26 FA 2002 (derivative contracts).

48. Section 83(2C) gives an exclusion from section 83(2B). It excludes all repayments of deposits from reinsurers, the discharge of debenture loans and loans from banks except where the receipt of the deposit or loan principal was brought into account in the revenue account (normally in Form 40 line 15) but was not taken into account for tax purposes. Accordingly loans that did not feature in Form 40 when received will not be subject to a charge under section 83(2B) on repayment, if the repayment does not feature in Form 40.

49. Section 83(2D) also excludes amounts if they are either the payment of the purchase price of investments or the disposal of such investments and the transfer is for at least the fair value of the asset.

This rule reflects Rule 3.2(4) of IPRU (INS) (previously section 29(4) ICA 1982).

50. Paragraph 2(3) makes a number of minor amendments to section 83(3) to make it clearer.

51. Paragraph 2(4) amends section 83(4)(c). The exclusion previously given for “exempt amounts” no longer has anything on which to bite. The new subsection (4)(c) makes it clear that there is no “addition” to the fund where money or assets are added to the fund in the ordinary course of buying and selling investments. But if a life company sells an asset to, say, its parent for an amount that exceeds its fair value, there is an addition to the fund of the excess. And if it buys an asset for no or insufficient consideration, that too is an addition.

52. Paragraph 2(5) is consequential on the changes made by paragraph 4 of Schedule 33 – see notes on that paragraph below.

53. Paragraph 2(6) and (9) makes some changes to the meaning of “total reinsurance”. That is a term which describes what is a substitute for a transfer of business, and the effect of section 83(3) to (8) is that an addition to the L-TIF of the company made in connection with a total reinsurance has the same tax effect as one made in connection with a business transfer under Part 7 FSMA. But there were two exceptions to the concept of “total reinsurance”. It did not apply where the reinsurer was a “pure reinsurer” charged to tax under Case I of Schedule D by virtue of section 439 ICTA. And it did not apply where the reinsurance was made before or simultaneously with the underlying policies. Both these exceptions have been exploited – so they are being removed, one from section 83(6) and the other from section 83(8).

54. Paragraph 2(7) introduces all the amendments to section 83(8). In addition to the change made by paragraph 2(9), a definition of “fair value” is inserted in section 83(8) by paragraph 2(8) – see paragraph 47.

55. Paragraph 2(10) amends the sidenote to section 83. At present it says “Receipts to be brought into account”. But “brought into account”, a term defined in section 83A FA 1989, simply means that an amount is reflected in the revenue account. Where receipts are to be taxable, they are described as being “taken into account”. That is what section 83 provides for, and so the new sidenote more accurately reflects the subject matter of the section.

56. Paragraph 2(11) gives the commencement rule for paragraphs 2(6) and 2(9). They have effect from 9th April 2003 - Budget Day.

57. Paragraph 2(12) gives the commencement rule for the rest of the paragraph – periods of account beginning on or after 1 January 2003.

Paragraph 3: contingent loans

58. In the life assurance field, a contingent loan means a loan made by a bank or maybe a parent or other group company or an advance made by reinsurance company, to a company carrying on life assurance business, to which special terms concerning repayment are attached.

59. What distinguishes them from other type of loan such as non-recourse loans (loans where the repayment may only be made out of specified assets or income, rather than with recourse to the assets of the debtor as a whole) is that repayment is only permitted where the insurance company generates sufficient “surplus” in a period that it meets the trigger condition in the loan for repayment (and sometimes interest).

60. They are particularly popular with life companies for solvency testing reasons. A life company must be able to show that at all times the value of its assets (determined in accordance with the Valuation Rules in IPRU(INS) exceeds the value of its liabilities (determined in accordance with same rules) by a given margin (a percentage) – the solvency margin.

61. If a life company borrows money on conventional terms, it increases its assets (cash, or more likely the asset acquired with the loan proceeds) but also increases its liabilities by the same amount. Since its liabilities increase, the assets it must hold to maintain its solvency margin are greater not only by the amount of the additional liabilities but also by a further percentage of them to maintain the same margin of solvency. So not only does a conventional loan not change the solvency position of the company for the better, it may make it worse.

62. Liabilities of an insurer are valued on two different bases according to their nature. Liabilities arising out of or in connection with the insurance business (typically the liabilities to policy holders – the “mathematical reserves”) are valued on an actuarial basis. Other liabilities are valued on an accounting basis, i.e. in accordance with UK GAAP (“Generally Accepted Accounting Practice”). This latter basis

will attribute to the loan a value equal to the amount repayable, so long as the interest charged on it is an arm's length amount

63. But a contingent loan falls to be valued on actuarial basis: the requirement that sufficient surplus be present before repayment is enough to make it a liability connected with the insurance business. And the actuarial value of such a loan is nil. Since the loan is only repayable out of future profits, an actuarial valuation will set the discounted value of those profits against the discounted value of the liability to repay and find they match.

64. Accordingly for solvency purposes a contingent loan increases assets but does not increase liabilities. In the periodical return to the FSA, where one would expect to find an account of liabilities (Form 14) there is no entry – it is only when a repayment is triggered would the amount repayable as a result of that trigger appear on Form 14 were one to be drawn up in the moment between the liability crystallising and the repayment being made.

65. It is not surprising that contingent loans have been popular – companies wishing to boost their solvency are not only keen to use them, the FSA, their regulator, is happy for them to be used, and both companies and the FSA are anxious that no tax obstacles be put in their way.

66. For its part, the Government is happy to oblige. But the Inland Revenue has also seen instances involving very large amounts of money where contingent loans have been used not to fortify a company's financial position by adding to its working capital or plugging a hole in its profits, but instead have been used to enable a company to make a very substantial distribution to its shareholders. Such distributions of amounts far larger than normal distributions have the economic effect of releasing the future profits inherent in the company's operations. Because of the very conservative way a life insurance company's liabilities are valued there is in many life company's liabilities a substantial excess over the amount that will reasonably be needed to pay policy holders. This is known sometimes as the free estate, or the embedded value.

67. The task then is to find a way of meeting the requirement to not tax inappropriately "good" contingent loans while ensuring that manoeuvres involving "bad" contingent loans are stopped. Many loans used simply to increase the company's solvency margins and to provide a cushion of

extra capital may be held outside the Form 40 as part of the difference between market value and book value of the company's assets. Such loans, where repayment is also not reflected in Form 40, should be entirely tax neutral.

68. But where contingent loans etc. have been used to free future profits embedded in the margins, that is to say, the excess of the company's reserves in respect of its liabilities to policy holders estimated using the very prudent actuarial bases required by the FSA Prudential Sourcebook over a realistic estimate of the value of those reserves, and there have been transfers representing such profits for the benefit of the shareholders of the company funded by the loans, then the legislation will result in receipt of the loan being brought into account for tax purposes.

Detail

69. Paragraph 3(1) inserts a new section 83ZA into Finance Act 1989.

70. Section 83ZA(1) defines a contingent loan. It is:

- any deposit received from a reinsurer or otherwise arising out of the insurance operations,
- any debenture loan or
- any loan or advance from a bank

which meets the condition that it was when received taken into account for tax purposes under section 83(2) FA 1989, because it was brought into account in the revenue account on Form 40. This will generally be the case where the loan receipt is shown on line 15 of that Form.

71. It might have been thought appropriate to have a second condition, such as that the loan would fall to be valued on an actuarial basis (that is, taking into account future profits of the life assurance business) for the purposes of a periodical return to the FSA deemed to be drawn up immediately on receipt of the loan. But it is not necessarily only contingent loans in the sense described in paragraph 59 above that are brought into account in the revenue account and are not reflected in Form 14. It is possible that the FSA might allow a waiver, using their powers in section 148 FSMA, of the requirement to enter the obligation to repay on Form 14, if the loan contains certain features even though it may not fall to be valued on an actuarial basis. Accordingly the

definition of contingent loan actually covers all loans that feature in Form 40 on receipt - but it is not thought that any “normal” loans would be so accounted for.

72. Section 83ZA(2) explains when a contingent loan is made for the purposes of the section. It is when the principal amounts are borrowed.

73. Section 83ZA(4) to (6) is the operative rule. If the company has received a contingent loan, and at the end of a period of account it has “unrepaid contingent loan liabilities” then:

- if the company did not have any unrepaid contingent loan liabilities at the end of the preceding period of account, section 83ZA(5) applies to allow as a trading expense the “appropriate amount” for the period.
- if it did, section 83ZA(6) applies, and if the appropriate amount at the end of the period exceeds the appropriate amount as at the end of the preceding period, the excess is allowed as a trading expense – section 83ZA(6)(a). If on the other hand the appropriate amount at the end of the period is less than the amount as at the end of the preceding period, the excess is taken into account as a receipt for the period of account - section 83ZA(6)(b).

74. “Unrepaid contingent loan liabilities” is defined in section 83ZA(3). A company has unrepaid contingent loan liabilities if there are any amounts of any one or more contingent loans which have not yet become repayable, for example because the contingency for its repayment has not yet been triggered.

75. Section 83ZA(7) defines “appropriate amount” as the amount of the unrepaid contingent loan liabilities at the end of the period, but as reduced by:

- “relevant net transfers to shareholders” and
- “deficiencies of assets over liabilities on relevant transferred business”.

The reduction cannot reduce the specified amount to a negative figure.

76. “Relevant net transfers to shareholders” means - section 83ZA(8) - the net amounts of transfers to the non-technical account as shown as a positive entry on line 26 of Form 40 in the FSA return, for all periods

between the period in which the relevant contingent loan was made and the period in question, but this disregards any “normal” transfers to shareholders

77. Section 83ZA(9) defines normal transfer to mean amounts which do not exceed 12% of the allocation, by way of bonuses, to policyholders in a period. 12% is very close to, but slightly larger than, one-ninth, which is based on the standard requirement in the constitutions of with-profits companies that distributions to shareholders cannot be more than that fraction of the bonuses awarded. Such companies are often known as 90:10 companies, because these are the proportions in which bonuses and shareholder transfers are made.

78. “Deficiencies of assets over liabilities on relevant transferred business” is defined in section 83ZA(10) to mean the amount by which the liabilities assumed by the company in respect of a transfer of business exceeded the amount brought into account by it on line 15 of Form 40 in respect of assets acquired as part of the transfer – the “element of the company’s line 15 figure representing the transferor’s L-TIF” – section 83ZA(12). Such deficiencies are only taken into account if the transfer took place since the making of the relevant contingent loan.

79. “Relevant contingent loan”, a term used in both section 83ZA(8) and (10), is defined in section 83ZA(11) to mean the contingent loan if there is only one, or the earliest made of more than one contingent loan still unrepaid to any extent at the end of the period in question.

80. If a contingent loan does become repayable, as a result of the trigger, and the repayment is brought into account on Form 40, then a deduction is given in respect of that amount in computing profits for the purposes of Case I – section 83ZA(13). But the amount so allowed cannot exceed the amount specified in section 83ZA(14), that is the amount found by taking the amount of the loan taken into account under section 83(2) and deducting any previous amounts of repayments in respect of that loan.

81. Examples of how and in what circumstances section 83ZA works:-

Facts

Suppose that in 2003 a company received a contingent loan of £100m and accounted for that receipt in Form 40 line 15.

In 2004 the contingency occurs and £20m becomes repayable, and is shown as an expense on line 25 of Form 40. There were no distributions to shareholders in 2003 or 2004.

Tax treatment

In 2003 there will be a receipt within section 83(2) of £100m. There will be a deduction under section 83ZA(5) equal to the unrepaid contingent liabilities £100m, because there have been no shareholder transfers.

In 2004 the opening figure under section 83ZA(6) is £100m. The closing figure is £80m, the unrepaid contingent liabilities, because there have been no shareholder transfers.

So £20m is brought into account under section 83ZA(6)(b).

The entry in Form 40 line 25 is £20m, the amount of the repayment, so a Case I deduction is given under section 83ZA(13) for £20m (as that does not exceed the amount brought into account under section 83(2) less earlier repayments £80m).

How and why this rule works in a case where there has been a transfer of surplus to shareholders can be explained by reference to a different set of facts.

Facts

Suppose there is a contingent loan of £100m in 2003, and the company transfers £45m out of the L-TIF so as to be available to shareholders.

In 2004 the contingency occurs and £20 million becomes repayable, and is shown as an expense on line 25 of Form 40.

In 2005 the rest of the liability is repaid.

Tax treatment

In 2003 there is a section 83(2) receipt of £100m. There will be a deduction under section 83ZA(13) of £55m, that is the unrepaid contingent liabilities £100m, reduced by shareholder transfers of £45m.

Thus a net amount equal to the shareholder transfer (£45m) is brought into account.

In 2004 the opening figure under section 83ZA(6) is £55m. The closing figure is £35m, the unrepaid contingent liabilities £80m reduced by shareholder transfers of £45m (£35m).

So £20m is brought into account under section 83ZA(6)(b).

A deduction is given under section 83ZA(13) of £20m (as that does not exceed the amount brought into account under section 83(2) less earlier repayments £80m).

In 2005 the opening figure under section 83ZA(6) is £35m. The closing figure is £0, the unrepaid contingent liabilities.

So £35m is brought into account under section 83ZA(6)(b).

A deduction under section 83ZA(13) is due of £80m.

So overall, the company has been taxed on a net amount of £0.

82. Paragraph 3(2) amends the loan relationships legislation as it applies to contingent loans. By virtue of paragraph 2(2) Schedule 11 FA 1996, Chapter 2 Part 4 FA 1996 – the loan relationships legislation – applies only to debtor relationships (liabilities) where a Case I profit of life assurance business is being computed. Thus it applies to contingent loans owing by a company carrying on life assurance business. In particular it may apply to amounts recognised in the company's statutory accounts, those drawn up under the Companies Act 1985, for example where amounts are included in other technical income in the technical account in respect of arrangements whereby the present value of future margins is used to repay contingent loans. Section 83(2) and (2B) and section 83ZA(10) all purport to affect the tax treatment of contingent loans. The question then is whether they are overridden in that attempt by section 80(5) Finance Act 1996 which gives priority to the loan relationships legislation unless there is an express provision to the contrary. The answer is that it does not - since what section 80(5) provides is only that amounts brought into account under Chapter 2 Part 4 FA 1996 are not otherwise to be brought into account: it has no application to the question of deductibility or taxability of amounts that are not in themselves profits or losses on loan relationships falling to be brought into account. No charge would be made and no relief would be due under that legislation for the mere receipt or repayment of a loan, as there is no profit or loss brought in account from that particular act which can be fairly represented by a credit or debit within the terms of

section 84(1) FA 1996. But to put the point beyond doubt, paragraph 2(2A) Schedule 11 FA 1996 is inserted into Chapter 2 Part 4 FA 1996. It provides that a contingent loan, as defined in section 83ZA(1) is to be treated not as a loan relationship as such, but simply as a money debt that is not a loan relationship. That means that section 100 FA 1996 will apply, and only interest and exchange gains and losses on the contingent loan will be brought into account. It also means that no deduction may be made in relation to the repayment of contingent loan otherwise than by virtue of section 83ZA(14).

83. Paragraph 3(3) gives the commencement rule. It has effect in relation to any loans received in a period of account beginning on or after 1 January 2003.

84. This raises the question what is the tax treatment in such a period of a contingent loan that was received in an earlier period and had not been fully repaid before the start of such a period. Any repayment which is brought into account in Form 40 is not deductible. Any repayment not so brought into account is excluded from section 83(2B) FA 1989 (see paragraph 46) unless it was brought into account in Form 40 on receipt and not taken into account for tax purposes.

Paragraphs 4 and 5: amendments of sections 83AA and 83AB FA 1989

Background

85. Section 83AA (together with section 83AB and subsections (4) to (8) of section 83) was added by Finance Act 1996 to supplement a recasting of section 83(3). Section 83AA applies if an addition to the L-TIF falling within section 83(3) and made to a transferee in connection with a transfer of long-term insurance business is not exhausted by a loss of the period in which the addition is made. Such an unexhausted addition is called a “surplus” (not to be confused with the surplus on valuation to which section 82B(1)(a) and section 432E(2) refer – see paragraphs 26 and 117). The surplus is applied first to reduce or extinguish a loss arising in the transferor of business, and then to losses of subsequent periods of the transferee. If business is subsequently transferred to another company, section 83AB provides rules for the carry over of surplus.

86. The carry back to the transferor provided by section 83AA(3) has not proved to be necessary, and is repealed.

87. Paragraph 4(1) repeals section 83AA(3), and makes consequential repeals of section 83AA(4) and (5) and in section 83AA(6), (7) and (10).

88. Paragraph 5(1) omits references to section 83AA(3) from section 83AB(1)(c) and makes consequential amendments to that paragraph.

89. Paragraphs 4(2) and 5(2) give the same commencement rule: they apply for periods beginning on or after 1 January 2003. Although these measures were not announced on 23 December 2002, and so are retrospective, they are wholly relieving.

90. As mentioned in paragraph 52, a reference to section 83AA(3) in section 83(5) is repealed by paragraph 2(5).

Paragraph 6: policy holder's share of profits

91. In order to make section 210A work more easily - see notes on paragraph 13 Schedule 33 - and to give clarity to expressions that have been difficult to construe, explanatory material has been added to section 88 and 89 FA 1989. This ensures that there is consistency between these sections, and other provisions dealing with shares of relevant profits.

92. Paragraph 6(1) inserts a new section 88(3A) FA 1989. This gives a full definition of what is meant by "income and gains of the company's life assurance business", namely:

- the income of the company's basic life assurance and general annuity business ("BLAGAB"), that is, any income charged under Schedule A or Cases III, V or VI of Schedule D, but not franked investment income.
- the BLAGAB chargeable gains reduced by allowable losses, so far as permitted by section 8(1) TCGA read with sections 210A and 213(3) of, and Schedule 7A to, the Taxation of Chargeable Gains Act ("TCGA") 1992
- the profits of the company chargeable under Case VI of Schedule D in respect of pension and ISA business, life reinsurance business and overseas life assurance business. The profits for each category are as reduced by losses of that category from earlier periods by virtue of section 436(3)(c), 439B(3)(c) and 441(4)(b) of ICTA.

93. Paragraph 6(2) provides that section 89 FA 1989 is amended. Paragraph 6(3) inserts a new section 89(1)(a) and (b) FA 1989. This gives a clearer description of what is constituted by the policy holders' share of relevant profits. At present, section 89 gives no indication of what parts of the relevant profits are charged at what rate – leaving it to be deduced, so far as necessary. Section 88A, which determines, until its repeal from 1 April 2003, what part of the policy holders' share of income is charged to corporation tax at a rate equal to the lower rate of income tax, works on the logical basis that the Case VI profits from non-BLAGAB business are part of the Case I profit, and will have first call on the amount of Case I profit and be taxed so far as possible at the mainstream rate, leaving any BLAGAB income and gains to take any remainder of the Case I profit, while the rest of the BLAGAB income and gains are the amounts taxed at policy holder rates.

94. The new section 89(1)(a) and (b) make this the clear basis, and is based substantially on section 88A(4) and (5). Section 89(1)(a) provides that where there are no Case I profits, the policy holders' share of the relevant profits will be all of them. This will be the case where the company carries on its business on a mutual basis, or where there is simply no Case I profit for the period.

95. Section 89(1)(b) deals with all other cases, that is where there is a Case I profit. The amount of the policy holders' share of relevant profits is that given by the new section 89(1A), inserted with new section 89(1B) by paragraph 6(4). First, the Case I profit is deducted, so far as it can be, from the aggregate of Case VI profits and losses, reduced by any charges on income referable to the categories concerned – section 89(1A)(a). Any balance of Case I profits is deducted from the BLAGAB profits of the company.

96. Section 89(1B) defines BLAGAB profits for this purpose. It takes the meaning that it had in section 88A(7), that is the income and chargeable gains referable (within the meaning of section 432A ICTA) to BLAGAB, less charges on income, management expenses and loan relationships non-trading deficits, so far as relating to BLAGAB. This definition of BLAGAB profits is now used in section 210A(10) TCGA 1992 (see notes on paragraph 13 of Schedule 33 and section 755A(11A)(c) ICTA).

97. Paragraph 6(5) makes a consequential amendment to section 89(2) (adjustment of Case I profit for FII), so that it refers to both section 89(1) and (1A).

98. Paragraph 6(6) amends section 76(2B) ICTA. This section determines what is the amount which is compared with the Case I profit for the purposes of the minimum profits test and the restriction of management expenses. At present section 76(2B)(a) simply refers to the “income and gains of the company’s life assurance business.” This is changed so that section 76(2B)(a) now refers to the income and gains referable to BLAGAB and a new section 76(2B)(c) refers to the Case VI profits under sections 436, 439B and 441 ICTA (pension, ISA, life reinsurance and overseas life assurance business). This makes it clearer what those income and gains of the life assurance business are.

99. Paragraph 6(7) amends two references to “the policy holders’ share of the relevant profits” that appear in section 434(6A)(a) and 434A(3) second sentence. At present these refer to section 88 FA 1989 for the meaning of the term. But section 88 nowhere defines the term - instead section 89 defines it for the purposes of section 88. So the reference to section 88 has been amended to read section 89. Section 89 is correctly used elsewhere in life assurance company legislation - in regulation 22(3) SI 1999/358, the Corporation Tax (Treatment of Unrelieved Surplus Advance Corporation Tax) Regulations.

100. Paragraph 6(8) makes a minor change to section 434A(1)(a)(i) ICTA. This subsection provide that where a company carrying on life assurance business surrender is charged to tax on the I minus E basis, but has incurred a loss in respect of that business computed in accordance with the rules of Case I of Schedule D, it may surrender the loss as group relief or set it against profits not arising from life assurance. But to avoid a double deduction, the amount of the loss is reduced by the amount of certain other deductions which are allowed in computing the profits chargeable under the I minus E basis. One of these amounts is the aggregate of any “charges on income” (primarily donations to charity under section 339 ICTA). The charges to which this adjustment applies are those which are allowed in computing the “profits or losses of the company’s life assurance business.” This too is somewhat imprecise, and is replaced by a reference to the company’s relevant profits within the meaning of section 88 FA 1989. By virtue of section 88(3)(c) FA 1989 this means those charges that are referable to the company’s life assurance business.

101. Paragraph 6(9) makes a similar change to section 437(1A) ICTA (annuities paid by a company deductible as management expenses up to

“income limit”) and paragraph 6(10) does the same for paragraph 16(1) Schedule 7 FA 1991 (deduction for pre-1991 annuities).

102. Paragraph 6(12) gives the commencement date – it is accounting periods ending on or after 9th April 2003 – Budget Day. But this is qualified in paragraph 6(11). Section 210A TCGA 1992 (see notes on paragraph 14 Schedule 33) uses section 89(1B) as a dictionary for the meaning of “BLAGAB profits”. But section 210A can apply to periods beginning before 1 January 2003, so paragraph 6(8) treats it as being in force in such periods for the purposes of section 210A.

Paragraph 7: Carry forward of losses

Background

103. Although the profits from life assurance made by most companies carrying on life assurance business are computed on the I minus E basis - see paragraph 303 - it is still necessary to compute the profits of all or parts of their life assurance business using the provisions of Case I of Schedule D (computation of profits of a trade) for various purposes, including:

- section 89 Finance Act 1989, to determine how much of the I minus E profits are shareholders’ profits (charged at normal corporation tax rates) and how much are policyholders’ profits (charged at reduced rates of corporation tax equal to the basic and lower rates of income tax)
- section 76(2) ICTA 1988, to set a floor below which any relief for management expenses cannot be allowed to reduce the I minus E profits
- loss relief - section 434A(2) ICTA
- assessment in those rare cases, including pure reinsurers by virtue of section 439A ICTA , where the company is assessed on an actual Case I basis rather than the I minus E basis
- sections 436, 439B & 441 ICTA to calculate the profits of pension, ISA, life reinsurance and overseas life assurance business.

104. Although it is a general rule of corporation tax that a loss is computed in the same way as a profit, and that losses may generally be carried forward from one accounting period to the next if not used in the

period they are sustained, there are exceptions to this in some of the provisions mentioned above. In a case where a company is actually charged under Case I, the rules for losses are exactly as they are for other companies. In the separate categories charged under section 436, 439B and 441, losses (computed in the same way as profits) may be brought forward from an earlier period. Where there is an actual Case I loss in a company charged on the I minus E basis, then the loss is computed in the same way as profits (subject to section 83(3) and 83AA FA 1989), but in practical terms it can only be used in the periods it is sustained (by offset against non-life profits or surrendered as group relief).

105. This leaves two other “notional” Case I computations. Under section 76(2) a company is required to test each year whether its Case I profits are greater than its I minus E profits, and if they are then its management expenses are limited to an amount which equalises the two figures. Historically, when the test in section 76(2) was one which compared tax bills under the two bases, the tax in the Case I profits part of the comparison could, by practice or concession, be calculated after reduction of the profit by any Case I losses of previous periods which had not been used under section 393A ICTA as set off against non-life profits or surrendered as group relief. When in FA 1996 section 76(2) was recast as a comparison of profits, not tax, the opportunity was taken to put into legislation the carry forward of “unused” losses in what is now section 76(2A)(a) and 76(2C) and (2D).

106. But section 89 (shareholders’ and policy holders’ shares) also involves the computation of a Case I profit - defined in section 89(7) to mean profits computed in accordance with the provisions of the Taxes Act applicable to Case I of Schedule D. The Case I profit is used in two distinct circumstances. In section 89(1) and (2) it is used to find the shareholders’ (and therefore policy holders’ share by subtraction) of the relevant profits. There is a second use, as the numerator of the fraction in section 89(3) (as further explained in section 89(4) to (6)). This fraction is used in a number of places in the life assurance provisions (fewer now than before) and in particular still to determine:

- the amount of franked investment income (“FII”) to be deducted from Case I profits in arriving at the shareholders’ share of relevant profits - *section 89(2)(b) FA 1989*.
- the amount of FII that can be used to frank for shadow advance corporation tax (“ACT”) - *regulation 22 SI 1999/358*

- the amount of FII left out of account in arriving at the ‘profit’ for small companies relief purposes - *section 434(3A)*
- the amount of excess underlying foreign tax attributable to BLAGAB that may be surrendered to another group company - *regulation 4(3) Double Taxation Relief (Surrender of Relievable Tax Within a Group) Regulations 2001 (SI 2001/1163)*
- the amount of corporation tax against which excess underlying foreign tax claimed from another group company may be set - *regulation 4(4) Double Taxation Relief (Surrender of Relievable Tax Within a Group) Regulations 2001 (SI 2001/1163)*

Detail

107. Paragraph 7(1) amends section 89(7) FA 1989 to provide that Case I profits, as defined in that subsection, means the profits of the period adjusted in respect of losses, and that the adjustment is made in the same way as profits are adjusted for losses in section 76(2A)(a) ICTA. That means that only losses of previous periods which have not been surrendered as group relief or set against non-life profits can be carried forward under the revised version of section 89(7), so long as they have not been set against Case I profits of an earlier period for the purposes of section 76(2) and 89(7).

108. Paragraph 7(2) is the commencement rule. The paragraph has effect for accounting periods beginning on or after 1 January 2003, but this is subject to a restriction, given by paragraph 7(3) of the losses that can be brought forward for a period earlier than the commencement period. Only losses actually incurred in the period immediately preceding the commencement period can be brought forward.

109. Note that the Double Taxation Relief (Surrender of Relievable Tax Within a Group) Regulations 2001 (SI 2001/1163) will be amended to make them compatible with section 210A and the changes to sections 88 and 89 FA 1989.

Paragraph 8: management expenses

Background

110. In order to complete the jigsaw in the area of “relevant profits”, and the shares of them, and of BLAGAB profits, and to provide a comprehensive account of what exactly constitutes the shareholders’ and

policy holders' shares, and how the meaning of BLAGAB profits and relevant profits fit together, section 76(1)(e) ICTA is amended. This gives a rule for the deduction of management expenses. The management expenses that may be deducted in a computation of profits under the I minus E basis includes only those that are referable to BLAGAB (section 76(1)(d) doing this job in negative fashion). Section 76(1)(e) then sets a limit on the amount of those BLAGAB management expenses that may be deducted – it is limited to the amount of the net income and gains referable to BLAGAB. The term “net income and gains” is in turn is defined in the fullout words of section 76(1) to mean the income and gains after deducting any reliefs or exemptions that fall to be applied before management expenses. What the reliefs here consist of seems to be just non-trading loan relationships deficits referable to BLAGAB – see paragraph 4(2) Schedule 11 FA 1996 for the ordering rule. Since paragraph 4(2) deducts those deficits from “net income and gains” before management expenses, and “net income and gains” has the same meaning as in section 76(1), there ought to be other exemptions or reliefs, but quite what they are is not easy to see.

111. But the limit having been established, nothing in section 76 or elsewhere says that the management expenses are only deductible from BLAGAB income and gains, and cannot be deducted from say a pension business Case VI profit, or even income or gains wholly outside the L-TIF. Deducting them from such income would generally give more effective relief because of the rates of CT applicable.

112. But sections 88 and 88A FA 1989 seem to operate on the assumption that management expenses are deductible first from BLAGAB income and gains. So as the various concepts and relationships in sections 88 and 89 (including as a result of doing away with section 88A) are being amended and clarified, section 76(1)(e) is recast.

Detail

113. Paragraph 8(1) recasts section 76(1)(e) and the fullout words in section 76(1). A new section 76(1)(e) provides that management expenses referable to BLAGAB can only be deducted from the income and gains referable to BLAGAB, after deducting any non-trading deficit on the company's BLAGAB loan relationships of the period.

114. A consequence of this change is that the words in section 87(6)(b) FA 1989 (pool of unused management expenses as at 31 December

1989) referring to a disregard of section 76(1)(e) are removed by paragraph 8(2). If there are still any companies which have a pool of unused pre-1990 management expenses, then in future they will only be deductible from BLAGAB profits.

115. Paragraph 8(3) amends paragraph 4 Schedule 11 FA 1996 which deals with non-trading deficits of a company carrying on BLAGAB. The word “net” is omitted in paragraph 4(2), as it is redundant. Similarly “net income and gains” is omitted from paragraph 4(16). The rules for carry back of deficits in paragraph 4(3) to (15) remain consistent with the revised section 76(1)(e).

116. Paragraph 8(4) gives the commencement rule - the paragraph applies for accounting periods beginning on or after 1 January 2003, so long as they end on or after 9th April 2003.

Paragraph 9: amendment of section 432E ICTA and other amendments

117. Paragraph 9(1) is introductory and paves the way for paragraph 9(2) and (4). They amend section 432E ICTA in consequence of new section 83(2B).

118. Paragraph 9(3) omits section 432E(2)(a). This paragraph provides that the assumption must be made that the investment return attributable to pension and ISA business, life reinsurance business and overseas life assurance business of a company which carries on life assurance on a mutual basis must always be such that no surplus is produced by these categories of business. As a matter of fact, many mutuals conduct themselves so that there is indeed no surplus carried forward after distribution of profits by way of bonuses. But there is no reason to make the assumption automatic if in fact the company does produce a surplus on its business. And in some cases, mutuals which have indicated their intention to demutualise have, under cover of this paragraph, disclosed very large amounts of surplus which have escaped taxation in the mutual, and have been used by the successor non mutual company to artificially reduce the taxable transfer from line 13 of Form 40, since bonuses can be paid out of the unallocated surplus inherited from the mutual. The repeal of section 432E(2)(a) will stop this, while not affecting genuinely mutual operations which do not reveal a surplus after bonuses.

119. Paragraph 9(4) inserts a new section 432E(2A). This allows any amounts taken into account as amounts within section 83(2) by virtue of section 83(2B) to be added to the “net amount” of investment return established by the “needs basis” calculation in section 432E(2).

120. The amount attributed to each category of business is found by a simple fraction, based on the one used in section 432E(2) (and found in the section 432E(2A) treated as inserted by SI 1997/473 in the case of a friendly society carrying on life or endowment business – which will be renumbered in due course by regulation). The numerator is the bonuses of the category, and the denominator the total bonuses. It will normally be apparent to which separate account required by the FSA (as defined in section 83A FA 1989), in a case where separate accounts are recognised, a section 83(2B) amount refers to. If a Form 14 is prepared for the separate account, it will be obvious. In other cases any attribution should be made according to the facts of the case.

121. Paragraph 9(5) gives the commencement rule. The amendments apply for periods of account beginning on or after 1 January 2003, except the repeal of section 432E(2)(a) which does not apply if such a period ends before 9 April 2003, Budget Day.

Paragraph 10: double tax relief

Background

122. Paragraph 10 amends two provisions in Chapter 18 ICTA 1988 which relate to the treatment of foreign tax suffered on income and gains of life assurance business. Section 804B has effect to apportion foreign tax to categories of income, with special rules where a Case I computation is being made. Section 804C also requires an apportionment of income that has suffered foreign tax where a Case I computation is made. The apportionment provisions in these two sections are a little obscure, and not entirely obviously saying the same thing. They are being amended so that they work more effectively and apportion foreign tax and the income to which it relates in an identical way.

Detail

123. Paragraph 10(1) amends section 804B(7). It provides that where an apportionment is to be made under section 432E of foreign tax, the company is to be treated as if its investment income is the whole of the

section 83(2) net amount. This will ensure that the net amount can never be negative, which can cause problems, especially if there is a negative numerator and positive denominator in the fraction for one category, and a positive numerator in another.

124. Paragraph 10(2) provides for the amendment of section 804C.

125. Paragraph 10(3) expands a shorthand term used in section 804C(4) and (5) to make the meaning clearer.

126. Paragraph 10(4) replaces section 804B(13) with a new subsection. This ensures that the fraction used in section 804B to apportion foreign tax to a category of business is also used for the purposes of section 804C to determine the amount of foreign income or gain referable to the same category.

127. Paragraph 10(5) gives the commencement rule - the amendments apply for accounting periods beginning on or after 1 January 2003, unless the period ends before 9th April 2003, Budget Day.

Paragraph 11: Company distributions

128. Paragraph 11 makes some amendments which were overlooked in 1997 when payable tax credits were abolished generally for companies and the foreign income dividend scheme was wound up.

129. Paragraph 11(1) amends section 76(2B)(b) ICTA. That subsection is part of the “minimum profits test, or “notional Case I”, restriction. An important part of the I minus E system is the ring-fencing of the element of the total profits of life assurance business that is the shareholders’ share and so charged to tax at mainstream rates of CT. In order to ensure that this profit is not reduced by policy holder reliefs, section 76(2) requires there to be a comparison of what would be the Case I profit if the company were charged to tax under that Case with the I minus E profits. If the Case I profits exceed the I minus E profits the management expenses given by section 76 are reduced by the excess.

130. The Case I profit is calculated, following section 434(1) to (1B) ICTA by bringing into account distributions from UK companies, but not, since 2 July 1997, any tax credit attaching to the dividends. The comparator, I minus E profits, is expressed to include franked investment income (“FII”) - this is defined in section 832(1) ICTA to

include a tax credit. The I minus E profit also is expressed to include any foreign income dividends (“FIDs”).

131. The amendment made by paragraph 11(1) is to remove the references to FII and FIDs and to substitute a reference to distributions from UK companies.

132. Paragraph 11(2) makes a minor change to section 434(3A) ICTA which governs how much of the FII of a company is ignored in determining whether the company is liable at the small companies’ rate or at the starting rate of corporation tax. At present the subsection refers to the FII “from investments held in connection with a company’s life assurance business”. This is replaced by a more precise reference to the investments of a company’s L-TIF. In the vast majority of cases the two are the same, but the change will avoid arguments at the margins where a company has UK shares held in its so-called “shareholders’ fund” and reflected in Form 16 of the FSA return.

133. Paragraph 11(3) removes references in section 441 ICTA (computation of profits of overseas life assurance business) to section 441A (distributions from UK companies referable to OLAB). Section 441A was repealed in the Finance (No. 2) Act 1997 and the references should have been omitted by that Act.

134. Paragraph 11(4) also removes references to FII in section 89(2) FA 1989 (adjustment of Case I profit for shareholders’ FII) and substitutes a reference to distributions from UK companies.

135. Paragraph 11(5) gives the commencement rule. The changes, apart from the amendments to section 441 (which will have effect from Royal Assent), have effect where a distribution is received on or after 9th April (Budget Day).

Paragraph 12: Rate of tax on policy holders’ share of life assurance profits

Background

136. Since 1989 there has been a rule, in section 88 Finance Act 1989, which specifically provides that the policy holders’ share of the relevant profits is to be charged at a rate of corporation tax (“CT”) deemed to be the rate at which income tax is charged at the basic rate. “Relevant profits” is defined in section 88(3) to mean the aggregate of the profits

charged under Case VI of Schedule D in respect of pension and similar business and the income and gains referable to basic life assurance and general annuity business (BLAGAB), less certain deductions such as management expenses.

137. This distinction between the policy holders' rate of CT and the mainstream rate is a main feature of the I minus E basis, recognising as it does that much of the income and gains of a company carrying on life assurance business accrues for the ultimate benefit of policy holders and is reflected in any profits they make on policies. Policy holders are entitled to a credit at the basic rate of income tax if they are liable to higher rate tax on the policy gains, and the policy holders' rate of CT is meant to reflect this.

138. In Finance Act 1996 this simple treatment was made more complex. In recognition of the fact that in the hands of an individual some income (so-called "savings income") became chargeable at the lower rate of income tax, 20%, a new rate of corporation tax, equal to the lower rate, was introduced in relation to that part of the policy holders' share of the a company's BLAGAB profits (the part of the relevant profits that does not relate to pension business etc.) that represented the lower rate income – paragraph 26 Schedule 6, inserting a new section 88A FA 1989. The objective was to identify a measure of profits accruing to policy holders derived from income that would have been taxed at the lower rate if received directly by them.

139. In section 26 FA 1999, individuals became taxed at 20% on their chargeable gains as well as on their savings income, but the policy holders' rate of CT on chargeable gains remained at a rate equal to the basic rate of income tax (now 22%). The Government has now decided to remove the perceived disadvantage to life companies of the differential rates for chargeable gains. And as reducing the rate on gains to 20% would leave only a small amount of an insurer's policy holder profits chargeable at 22%, then in the interests of simplification all policy holder profits, both income and chargeable gains, become chargeable at the 20% rate.

140. A corollary of this change is that the rate of income tax treated as paid when a policy holder makes a gain on a policy is reduced to the lower rate of income tax (20%). This is effected by section 172 and Schedule 35 and has effect from 6th April 2004. An individual whose income includes a policy gain will only have more tax to pay on the gain as a result of this reduction in the rate if he or she is liable to income tax

at the higher rate. Trustees, other than trustees of a charitable trust, whose income includes such a gain will also have a higher tax liability on a gain, being tax at a rate equal to the difference between the rate applicable to trusts and lower rate instead of the difference between the rate applicable to trusts and the basic rate. The change to the rate of tax will make no difference to the tax liability of personal representatives for the estate of a deceased individual.

Detail

141. Paragraph 12(1) provides that FA 1989 is amended.

142. Paragraph 12(2) amends section 88 FA 1989 which gives the main rule for charging the policy holder profits. Instead of “basic rate” it will now say “lower rate”. The lower rate is defined in section 1A(1B) ICTA as 20%.

143. Paragraph 12(3) repeals section 88A FA 1989. This was the provision, introduced in 1996, which charged savings income at the lower rate. The section is unnecessary now there is only one policy holders’ rate.

144. Paragraph 12(4) makes a consequential amendment to section 89(1) (which determines what is meant by the policy holders’ share of profits – see notes on paragraph 7 Schedule 33). The reference to section 88A is omitted. Words referring to BLAGAB, which relate to section 88A are also repealed.

145. Paragraph 12(5) provides that ICTA 1988 is amended, as a consequence of the repeal of section 88A.

146. Paragraph 12(6) makes a consequential amendment to section 438B(5)(a) ICTA (income from property owning limited liability partnership), and section 438B(5)(b) is repealed.

147. Paragraph 12(7) provides for the amendment of, and paragraph 12(8) and (9) amend, section 755A ICTA – controlled foreign company (“CFC”) profits attributable to company carrying on life assurance business.

148. Paragraph 12(8) and (10) omit references to section 88A FA 1989 in section 755A(3) (CFC profits) and paragraph 5(6)(b) Schedule 28AA (transfer pricing).

149. Paragraph 12(9) recasts section 755A(11) to determine what is the “policy holders’ part” of a CFC profit that has been apportioned to the company’s BLAGAB.

150. New section 755A(11)(a) defines the “policy holders’ part” as all of the BLAGAB apportioned profit in a case to which section 755A(11A) applies, that is:

- where the company’s life assurance business is mutual business
- where the policy holders’ share of relevant profits is all of them
- and where the policy holders’ share of relevant profits is greater than the BLAGAB profits.

This subsection reflects the rule in section 88A(4) FA 1989 which is now repealed.

151. In a case where new section 755A(11A) does not apply, new section 755A(11)(b) defines the “policy holders’ part” as being the relevant fraction of the profit, as defined in new section 755A(11B), that fraction being:

$$\frac{\text{the policy holders' share of relevant profits}}{\text{the company's BLAGAB profits}}$$

This reproduces the fraction in section 88A(5)(b) FA 1989..

152. Section 755A(11C) provides that a term used in section 755A(11A) and (11B) has the same meaning as in section 88(3) and 89 FA 1989.

153. Paragraph 12(11) gives the commencement rule. Paragraph 12 applies for the financial year 2003 and later financial years. Financial years are years beginning on 1 April. Where, as will usually be the case, an insurance company’s accounting period does not coincide with the financial year, the relevant profits must be apportioned on a time basis - section 8(3) ICTA.

Paragraph 13: ring-fencing of chargeable gains and allowable losses

Background

154. One of the basic principles underlying the I minus E basis of taxation, which is the basis of taxation normally applied to companies carrying on life assurance business (see paragraph 303 onwards) is that a clear distinction is made between the policy holders' interest in the taxable profits of the company and the shareholders' interest. There are two types of "ring-fencing" which reflect a more precise and a less precise identification of the respective interests. In some cases the distinction is between what is in the L-TIF and what outside it. Examples of the less precise distinction between the L-TIF and the rest of the company are the restriction on the use of management expenses and amounts treated as such expenses, and section 440(3) ICTA which prevents section 171 TCGA (no gain/loss transfer) where the asset ceases to be or becomes an asset of the L-TIF.

155. The more usual distinction, and the more precise one, is one that separates the shareholders' share of the profits of the relevant business (the business of life assurance) from the policy holders' share. The shareholders' share then receives the same tax treatment as any other profits of the company arising from activities other than life assurance. The basic rule here is the one in sections 88, 88A and 89 FA 1989, which determine the tax rates applicable to each part. A further important ring-fencing rule is section 434A(3) ICTA which prevents loss relief, group relief and non-trading loan relationship deficits from outside the life assurance business from being set off against the policy holders' share of profits.

156. There is however no clear and obvious rule which prevents a set-off of allowable losses arising from disposal of assets held outside the L-TIF against the policy holders' share of chargeable gains from long term business fund assets. "Allowable losses" are losses on the disposals of assets which, if producing a profit would produce a "chargeable gain" within the meaning of TCGA. Nor is there any clear and obvious rule preventing a set off of allowable losses arising from disposal of assets held within the long term business fund from being set against gains arising on assets held outside that fund. It may be inferred from the structure of section 88(3) FA 1989 (as substituted by Schedule 8 FA 1995) that the policy holders' share of gains cannot be the subject of a deduction for losses accruing on gains from the disposal of non L-TIF assets, but the point is not clear cut.

Detail

157. Paragraph 13(1) clarifies the ring-fencing rules for chargeable gains and allowable losses by inserting a new section 210A into the TCGA.

158. Section 210A(1) provides that the normal rules for allowable losses in section 8(1) TCGA 1992 apply to insurance companies, but are subject to the rest of section 210A. Section 8(1) provides that the chargeable gains to be brought into account as part of the total profits of the company are all the gains accruing in the period, after deducting all the losses accruing in the period, and any losses accruing in any post-1965 accounting period which have not been deducted from gains in an earlier period.

159. Section 210A(2) sets out the rule in a case where non-BLAGAB allowable losses accrue. Non-BLAGAB allowable losses are defined in section 210A(13) as any allowable losses which are not BLAGAB losses (also there defined), which in turn means allowable losses referable to the company's BLAGAB. Losses are "referable " to BLAGAB if they are so referable in accordance with the apportionment rules in section 432A Income and Corporation Taxes Act 1988 ("ICTA"). But the exemption from tax for gains referable to pension and ISA business, life reinsurance business and overseas life assurance business, and the effective exemption for losses referable to permanent health insurance means that non-BLAGAB losses consist of losses on assets which are not assets of the company's L-TIF.

160. The rule in section 210A(2) is that non-BLAGAB allowable losses cannot be deducted from the policy holders' share of BLAGAB chargeable gains. But they are deductible from the shareholders' share of any BLAGAB gains, as well as from non-BLAGAB gains. Non-BLAGAB losses cannot therefore interfere with the calculation of the policy holders' share of relevant profits on which a reduced rate of corporation tax is charged. BLAGAB gains and BLAGAB losses are also defined in section 210A(13) as meaning gains and losses referable to BLAGAB.

161. Section 210A(3) is the opposite of the rule in section 210A(2). But it operates in a different way. It provides that BLAGAB allowable losses are available against non BLAGAB gains, but only to the extent permitted by the rest of the section, and not otherwise.

162. Section 201A(4) sets out the first limitation. BLAGAB allowable losses can only be set against non-BLAGAB gains if there are any available after non-BLAGAB losses of the period, and any unused non-BLAGAB losses brought forward have been deducted.

163. Section 210A(5) sets out the second limitation. BLAGAB allowable losses are only deductible from non-BLAGAB gains to the extent are within the “permitted amount”.

164. Section 210A(6) defines the “permitted amount” for the first accounting period for which section 210A(5) applies – which will be the accounting period in which 23 December 2002 falls, or if the company did not have an accounting period containing that date, its first accounting period to start after that date.

165. The permitted amount for this first period is the aggregate of:

- the excess, if any, of the shareholders’ share of BLAGAB losses over the same share of BLAGAB gains accruing in the period, and
- the shareholders’ share of BLAGAB allowable losses which accrued before the first period, and which are not deducted from any gains in any period before the first period – i.e. the brought forward losses.
- The shareholders’ share applied to these brought forward losses is the share for the period immediately preceding the first period, irrespective of when the losses accrued.

166. Section 210A(7) defines the “permitted amount” for any accounting period after the first accounting period for which section 210A(5) applies. The permitted amount for such a period is found by:

- deducting from the permitted amount of the immediately preceding period the amount of any BLAGAB losses that have actually been deducted from non-BLAGAB gains for that period, and
- adjusting the result as given as set out in subsections (8) and (9).

167. Section 210A(8) applies if in the period concerned the BLAGAB allowable losses accruing in the period exceed the BLAGAB chargeable

gains accruing in the period. Section 210A(9) applies if the reverse is the case. If the BLAGAB gains and losses in the period are identical, no adjustment is made.

168. The section 210A(8) adjustment is to reduce the amount found in accordance with the first bullet in paragraph 166 by a fraction whose

- whose denominator is the BLAGAB allowable losses accruing in any previous accounting period which have not been deducted from gains accruing in such a period, and
- whose numerator is the amount of those losses which are deducted from BLAGAB gains accruing in the accounting period.

169. The section 210A(9) adjustment is to increase the amount found in accordance with the first bullet in paragraph 166 by the shareholders' share of the amount by which the BLAGAB allowable losses of the period exceed the BLAGAB chargeable gains of the period.

170. Section 210A(10) defines the "policy holders' share" of gains or losses and the "shareholders' share" of such gains or losses. Unlike the draft legislation published on 21 January, it is based on the definition of "policy holders' share" used in sections 88 and 88A FA 1989 to find the policy holders' share of relevant profits – section 210A(13) makes the connection. The change has been made in connection with the rationalisation of the computation of relevant profits and the policy holders' share – see notes on paragraph 6 of Schedule 33.

171. The policy holders' share of chargeable gains or allowable losses is, in a case where the policy holders' share of relevant profits exceeds the BLAGAB profits, the whole of those gains and losses. BLAGAB profits takes it meaning from the new section 89(1B) FA 1989 – see notes on paragraph 6 Schedule 33.

172. In any other case the policy holder's share is a fraction:-

$$\frac{\text{policy holders' share of relevant profits}}{\text{relevant profits}}$$

the same fraction as that given in section 88A(5)(b) FA 1989 (but see also the notes on paragraph 12 of Schedule 33 concerning the repeal of section 88A.

173. The shareholders' share of chargeable gains or allowable losses, defined in section 210A(12) can also be expressed as a fraction,

$$\frac{\text{Relevant profits less policy holders' share of relevant profits}}{\text{relevant profits}}$$

174. For the purposes of determining the policy holders' and shareholders' share for a period, any carry back of allowable losses under

- section 213(3) TCGA (deemed disposal of holdings in unit trusts, OEICs etc.)
- section 202 TCGA (losses on mineral leases)

is disregarded, as is the carry back of a non-trading loan relationships deficit under paragraph 4(3) Schedule 11 FA 1996 - section 210A(11).

175. The workings of this section can be better seen with an example:

Suppose that a company has calendar year accounting periods.

There are BLAGAB losses of £5m available at the end of **2000** to carry forward.

In **2001**, there are BLAGAB gains of £10m, BLAGAB losses of £25m, and no non-BLAGAB gains or losses. The "shareholders' share for the period is 10%.

In **2002** there are BLAGAB gains of £12m, BLAGAB losses of £20m, non-BLAGAB gains of £6m accruing on 30 December 2002 and non-BLAGAB losses of £3m. The "shareholders' share for the period is 20%.

The "permitted amount" for **2002** is found by section 210A(6). To find it:

Take the shareholder's share of BLAGAB losses of the period = 20% x £20m = £4m

Take the shareholder's share of BLAGAB gains of the period = 20% x £12m = £2.4m

The excess, £1.6 m is the section 210A(6)(a) amount.

Look at the position the end of 2001.

Take the BLAGAB losses not deducted for that or earlier periods =
£15m (£25m - £10m) + £5m (from 2000) = £20m

Take the shareholder's share for that period of those losses = £20m x
10% = £2m. This is the section 210A(6)(b) amount

The total permitted amount is £3.6m

Take the post 22/12/2002 non-BLAGAB gains of the period = £6m

Deduct the non-BLAGAB losses (£3m) = £3m = available non-
BLAGAB gains (as required by section 210A(4)).

The amount to be deducted from non-BLAGAB gains is the lesser of the
permitted amount (£3.6m) and the available non-BLAGAB gains (£3m).

Thus £3m is deducted from the non-BLAGAB gains. £.6m is available
to carry forward.

In **2003** there are BLAGAB losses of £14m and non-BLAGAB gains of
£3m and non-BLAGAB losses of £1 million. The "shareholders' share
for the period is 15%.

The "permitted amount" for **2003** is found by section 210A(7). To find
it:

Look at the position the end of 2002.

Take the permitted amount for 2002 = £3.6m

Deduct the amount used against non-BLAGAB gains in 2002 = £3m

The result = £0.6m is the section 210(7)(a) amount

Find out if BLAGAB gains of 2003 exceed BLAGAB losses or vice
versa

BLAGAB losses exceed BLAGAB gains by £14m (£14m - £0), so
section 210A(9) applies.

Take the section 210(7)(a) amount = £0.6m

Add the shareholders' share of the section 210A(9) excess = £14m x 15% = £2.1m, to find the permitted amount for 2003 = £2.7m.

Take the non-BLAGAB gains of the period = £3m

Deduct the non-BLAGAB losses (£1m) = £2m = available non-BLAGAB gains.

The amount to be deducted from non-BLAGAB gains is the lesser of the permitted amount (£2.7m) and the available non-BLAGAB gains (£2m).

Thus £2m is deducted from the non-BLAGAB gains.

In **2004** there are BLAGAB gains of £24m, BLAGAB losses of £4m, non-BLAGAB gains of £8m and non-BLAGAB losses of £2m. The "shareholders' share for the period is 12%.

The "permitted amount" for **2004** is found by section 210A(7). To find it:

Look at the position the end of 2003.

Take the permitted amount for 2003 = £2.7m

Deduct the amount used against non-BLAGAB gains = £2m

The result = £.7m is the section 210(7)(a) amount

Find out if BLAGAB gains of 2004 exceed BLAGAB losses or vice versa

BLAGAB gains exceed BLAGAB losses by £20m (£24m - £4m), so section 210A(8) applies.

Take the section 210(7)(a) amount = £0.7m

Reduce it by the fraction:-

BLAGAB losses of earlier periods deducted from BLAGAB gains in 2004 = £20m, over

Unused BLAGAB losses of earlier periods = £5m (brought forward from 2000) + £15m (2001) + £5m (2002) + £12m (2003) = £37m

Permitted amount which may be deducted from non-BLAGAB gains = £0.7m x (37-20)/37 = £0.32m

The amount to be deducted from non-BLAGAB gains is the lesser of the permitted amount (£0.32m) and the available non-BLAGAB gains (£6m).

176. Paragraph 12(2) and (3) gives the commencement rule. The section applies to accounting periods straddling 22/23 December 2002 and any subsequent periods, but the limitation of the deductibility of losses from gains applies only to gains accruing on or after 23 December 2002.

Paragraph 14: Bed & breakfasting

Background

177. This paragraph is aimed at preventing bed and breakfasting by life assurance companies. Section 106 TCGA is the rule that was introduced as section 58 Finance (No. 2) Act 1975 to discourage the practice of bed and breakfasting, that is selling shares standing at a loss by reference to their base cost and buying them back the next day. That section operates by identifying shares disposed of with shares acquired in a “prescribed period”, which is, for deals on a Stock Exchange, 30 days before and 30 days after the acquisition (same day transactions are identified under a different rule). The section requires acquisitions by other group members to count as acquisitions by the disposing company, but does not apply unless the holding of shares amounts to 2% or more of the issued share capital.

178. When introduced section 58 applied to assets held in connection with life assurance business in the same way as it applied to other companies. Companies carrying on life assurance business were excluded from the section in 1990 as part of the major reforms of life assurance company taxation in that year. But since 1990 companies have continued to practice “bed and breakfast” manoeuvres but using the “internal” route exploiting the rules in section 440 ICTA instead.

179. Section 440 ICTA was substituted in 1990 for a previous version and was intended to do a number of things. It threw a ring-fence around the L-TIF so that the no gain/no loss transfer rules in section 171 did not apply to transfers into and out of the L-TIF. See the notes on paragraph 15 of Schedule 33 for further measures concerning section 171 transfers.

180. Section 440 also carved the L-TIF up into a series of “boxes” as they have come to be known, together with a box consisting of assets held outside the L-TIF. This was to prevent companies taking advantage of that fact that for some categories of business, a disposal of the assets referable to them was exempt from corporation tax. This applies in particular to assets held to back pension business. Without section 440, an asset pregnant with gain might, by the stroke of a pen or the press of a computer key, cease to be one on which a gains would arise. Conversely, an asset standing at a loss but in circumstances where the loss was not allowable, could be moved into an allowable loss category.

181. Section 440 as substituted in 1990 provides that if an asset was treated in the books and records of the company as having moved from one box to another, there was deemed to be a disposal (and reacquisition) of it for the purposes of the Corporation Tax Acts (not just for chargeable gains purposes).

182. Some companies discovered that if they transferred an asset standing at a loss from one (taxable and hence allowable) category to another, and then next day reacquired it in the original box, the deemed disposal would trigger an allowable loss, but that box would still have, after a few hours delay, the same asset available to it.

183. With the bull market of the late nineties the stock of assets standing at a loss diminished, but the bear market of the last few years has replenished the stock of such assets. In order to put a stop to increased activity in this area, and to prevent a revival of external bed and breakfasting, paragraph 14 inserts a new section 210B into TCGA 1992. It is substantially different from, and replaces, two provisions contained in the draft legislation published on 21 January 2003. It has been developed in closed consultation with the insurance industry.

Detail

184. Section 210B(1) gives the case for the operation of the section. It applies where there would, but for the section, be an allowable loss

(within the meaning of TCGA) accruing as a result of a disposal, including a deemed disposal as a result of a “box” transfer within section 440, where:

- the assets disposed of is a section 440A security
- there is an acquisition of a section 440A security
- the section 440A securities disposed of decrease the size of a holding which is of assets linked to BLAGAB or is referable in part to BLAGAB
- the section 440A securities acquired increase the size of the same type of holding
- the disposal and acquisition were within 10 days of each other (irrespective of which came first).

185. Section 210B(8) defines “section 440A security” to mean a security within the meaning of that section of ICTA. This means all assets which fall within the pooling rules of section 104 TCGA, namely shares, securities and any other assets which are of a type that they can be dealt in without identifying the particular assets disposed of. This includes fungible assets of any type such as currency, commodities etc. But “relevant securities” within section 108 TCGA are excluded. Most relevant securities are not chargeable assets because they are excluded by section 115 TCGA – gilts and qualifying corporate bonds – but securities falling within sections 92 and 93 FA 1996 will be relevant securities, as will material interests in a non-qualifying offshore fund.

186. Section 210B(2) to (4) gives the identification rules where the section applies. They are based on those in section 106 and have the same effect. The securities disposed of mentioned in section 210B(1) are identified with those acquired mentioned in that subsection. There are also rules for determining what happens if there is more than one acquisition within the 10 day period.

187. Section 210B(5) mirrors section 106(9) TCGA and provides that the section yields to the same day rule in section 105 TCGA. However it has priority over the general identification rules in section 107 TCGA.

188. Section 210B(6) provides two exceptions to the main rule. Firstly, it does not apply where the assets are deemed to be disposed of and

immediately reacquired as a result of section 212 TCGA – section 210B(6)(a). That section deems a company carrying on life assurance business to have disposed of and reacquired at the end of each accounting period its holdings of “section 212 assets”, that is its holdings in authorised unit trusts, open-ended investment companies (“OEICs”) and certain holdings in offshore funds which are assets within the scope of charge of TCGA.

189. Secondly the main rule does not apply where paragraph 3 Schedule 19AA ICTA applies – section 210B(6)(b). That paragraph requires assets to be added to, or subtracted from, a company’s overseas life assurance fund (“OLAF”) in a particular order if at the end of a period the company’s OLAF is greater or less than the opening figure. It would be inappropriate to deny a loss if a company has little or no option as to what assets it transfers.

190. Section 210B(7) provides another exception. It deals with “balancing” transactions where the assets disposed of or acquired are held in a “BLAGAB internal linked fund”, and where the disposals and acquisitions are made with a view to ensuring an exact match between the assets and liabilities of BLAGAB linked funds.

191. An “internal linked fund” is a fund established as part of the accounting arrangements for linked business, and is defined for the purposes of section 210B as it is in section 432ZA ICTA – section 210B(8). A lot of life assurance business is written on the basis that what the policy holder receives on the maturity of his policy is an amount equal to the value of particular assets, the broad nature of which may be chosen by the policy holder (e.g. land or shares in companies listed on a particular stock exchange or in a particular industry). This is known as unit linked or property linked business. Regulatory rules require the company to hold the actual assets by reference to the value of which the policy payouts are linked. This type of policy is very similar to a unit trust or OEIC, and the company in fact notionally allocates “units” to the policy holder based on the amount of premium paid. The premiums and the assets bought with them are accounted for in a separate fund, an “internal linked fund”, which contains the assets and premiums for all the policy holders who wish to invest in the particular assets concerned.

192. Because premiums and payouts are happening at regular intervals, and often the cash coming in will not match the cash going out, the value of the assets in the fund has to be adjusted to ensure the exact

match with liabilities. These adjustments are often small, but as they can be made weekly or even more frequently, it would be possible for these transactions to fall foul of the main rule's 10 day prescribed period. So this type of disposal and acquisition is excluded from the main rule.

193. Section 210B(8) gives definitions. "Section 440A securities" is used in section 210B(1) and is explained in paragraph 185 above. "Chargeable section 440A holding" is also used in section 210B(1), and is defined to cover only those section 440A securities which fall within section 440A(2)(a)(iii) – assets solely linked to BLAGAB – and section 440A(2)(d) – assets neither solely linked nor referable to OLAB.

194. The other definitions relate to the exception in section 210B(7) – see paragraph 190 above.

195. Paragraph 14(2) gives the commencement rule. Section 210B will apply in relation to disposals on or after 23 December 2002. Paragraph 14(3) allows a relaxation where there are losses accruing to a company from disposals in the period 23 December to 31 December 2002 (whether its accounting period ended on that latter date or not). The bed and breakfasting rules only apply where, but for these rules, losses of £10 million or more would have accrued on those disposals.

Paragraph 15: Notional intra-group transfers.

Background

196. Section 171A TCGA was introduced in FA 2000. Before its enactment there was no form of group relief for allowable losses within the meaning of TCGA. Instead there was a well known practice of transferring an asset from one company (A) to another in the group (B) using section 171 TCGA which provides that a transfer between two companies in the same group is treated as made for a consideration which gives neither a gain nor a loss – a "tax neutral transfer". B then transfers the asset to C which will be a company outside the group and to which A would, but for the lack of a group relief system for gains, have sold directly. The object of the intermediate sale to B would be to ensure that a gain that would otherwise have been made by A, but which would have been subject to tax, is instead made by B which has allowable losses to set against it – or vice versa.

197. Section 171A was enacted to remove the necessity of making an actual transfer with its attendant costs. Instead A and B can jointly elect that there is deemed to be transfer by A to B followed by an immediate sale by B to C. However, it is a condition of the election being successfully made that if there had been an actual transfer from A to B section 171 would have applied.

198. For most companies this condition is clearly capable of being fulfilled by simply providing that A and B are in the same group. But section 171 only applies in very limited circumstances where a company carrying on life assurance business is concerned. Section 440(3) ICTA provides that section 171 does not apply to a transfer of an asset held in a company's L-TIF, or to a transfer to a company's L-TIF. In the case of a mutual life insurance company all its assets will be in its L-TIF. In many other cases the overwhelming preponderance of assets will be so held.

199. It is therefore impossible to say that in a case where company B is a company with a L-TIF that section 171 would have applied to an actual transfer from A to B.

200. There is no policy reason why section 171A should not apply to a transfer to a company carrying on life assurance business so long as the integrity of section 440(3) and of the new section 210A(1) (see notes on paragraph 13 above) are not impugned.

Detail

201. Accordingly, paragraph 15(1) and (2) amends the TCGA by inserting a new section 171A(3A) into that Act.

202. That new subsection relaxes the prohibition in section 171A(3) where B is an insurance company. An election may now be made by an insurance company B (with A) but the effect of the election in such a case is that the asset is treated as being held for the deemed moment before the sale to C otherwise than in the company's L-TIF.

203. The second sentence of new section 171(3A) also gives definitions, using section 431(2) ICTA as the dictionary.

204. Example

Suppose that on 1 January 2002 A plc holds shares in Z Ltd which would if sold give rise to an allowable loss of £15,000,000. A Life Ltd

has chargeable gains of £75,000,000 expected to accrue in 2002 and a similar amount in 2003.

If A plc transferred the shares to A Life Ltd (but not so the shares became assets of its L-TIF) in a section 171 transfer, and A Life Ltd then sold the shares in Z Ltd outside the A plc group, A Life Ltd would have an allowable loss of £15m.

If however A plc and A Life Ltd purported to make a section 171A election to avoid the cost of the intermediate transfer it would not be valid.

If however the disposal outside the group occurred on or after 23 December 2002, A plc and A Life Ltd could make a valid election, the shares in Z Ltd would be deemed to be transferred to A Life Ltd but not so as to become an asset of its L-TIF, and the allowable losses of £15m would be available to A Life Ltd subject to section 210A(1) TCGA.

205. Paragraph 15(3) makes a minor consequential amendment to section 171A(4) and paragraph 15(4) gives the commencement rule. Section 171A(3A) will apply in relation to disposals (to C) on or after 23 December 2002 (the date of announcement).

Paragraphs 16 to 22: Transfers of insurance business

Background: business transfers

206. In the absence of special provisions, if a company carrying on life assurance business wished to transfer its business or part of its business to another such company, there would be substantial difficulties and inconvenience involved. This is because, under English law at least, it is not possible to transfer liabilities without the consent of the creditor. Since a company carrying on life assurance business has in many cases thousands if not millions of creditors in the shape of policy holders, obtaining the consent of all them would be very difficult. Accordingly there has long been a process under which transfers of business could be made without the policy holders' consent if the transfer is sanctioned by the High Court, or in Scotland, the Court of Session.

207. The current provisions for this sanction are in Part 7 FSMA and such transfers are described in this note as "Part 7 transfers". They are still often referred to as Schedule 2C transfers, as the previous rule was in that Schedule to the ICA.

208. In 1990 a number of special tax provisions were enacted to deal with transfers of business. Their object was primarily to provide a “stand in shoes” or tax neutrality rule where assets were transferred, and to allow carry over of reliefs which would otherwise be lost on the cessation of business of the transferor. The reliefs were intended to recognise that although the shareholder ownership of the business may have changed, the same policy holders had their interest in the business before and after, and that matters which related to the taxation of the policy holders’ interest in company’s income gains or profits should be unaffected by the change of company.

209. In addition, section 12(7A) ICTA was enacted to bring an accounting period of the transferor to an end where there was a transfer of business if it would not otherwise do so.

210. Some gaps and weaknesses in the tax rules concerning Part 7 transfers have become apparent. In addition some companies have used Part 7 transfers as an opportunity to ensure that income and profits escape taxation altogether. Paragraphs 11 to 18 of the Schedule prevent these tax free extractions of profit and make other changes to the Part 7 transfers tax neutrality rules.

Paragraph 16: Transfers of business: deemed periodical return

Background

211. A great many of the tax rules for life assurance companies are based on entries in the FSA return, the periodical return made to the Financial Services Authority under Rule 9.3 IPRU (INS). When a company transfers its entire long term business under a Part 7 FSMA transfer, it may be excused by the FSA from depositing a periodical return for the period ending with the transfer or which straddles the transfer. This is because once a company has ceased to carry on business, the FSA, whose prime interest is in the solvency of continuing insurers, does not need to monitor the solvency of a now ceased insurer.

212. The lack of a periodical return means that many of the figures used to make apportionments of income and gains are missing:

- opening and closing liabilities are needed for sections 432A(6), 432C(4), 432D(3), 432E(3) and regulation 5 SI 1990/1541, paragraphs 16(2) and 17(4) Schedule 7 FA 1991 and section 255 Capital Allowances Act 2001

- opening and closing values or net values of assets are needed for sections 432A(6), 432C(4), 432D(3), 432E(3) and regulation 5 SI 1990/1541.
- opening and closing amounts of the investment reserve are needed for section 432A(6).
- and the absence of a revenue account in Form 40 and of Forms 13, 14 and 58 may make it impossible to determine the Case I profit of the period.

Detail

213. Paragraph 16(1) inserts a new section 444AA into ICTA to rectify this position.

214. Section 444AA(1) gives the case. It applies where there is an insurance business transfer scheme, which is defined in section 444AA(4) to mean both:

- a scheme falling within section 105 FSMA, including an excluded scheme falling within Case 2, 3 or 4 of subsection (3) of that section, and
- a scheme falling outside it as a result of its failing to meet the condition in section 105(1)(b).

Section 105 relates to transfers of long-term insurance business (which includes life assurance business). The excluded cases are those where a transfer scheme does not require, but may involve, Court sanction. Section 105(1)(b) provides that the section only applies if the transferred business is to be carried on from an establishment of the transferee in an EEA state. Section 444AA applies where there is an insurance business transfer scheme that transfers the whole of the long-term business of the transferor company, if the last periodical return made by that company was for a period that did not end immediately before the transfer. Thus whether the last return was for period ended on the day before, 18 months before or 2 seconds after the transfer, the section applies.

215. Section 444AA(2) gives the operative rule. The company is deemed to produce a periodical return for the period starting with the day following the date to which the last return was made, and ending

immediately before the transfer takes place. As foreshadowed above, this period may be for 2 seconds or it may be for more than 12 months.

216. The deemed periodical return must contain such entries as would have been contained in an actual return made for the period. Inland Revenue guidance will indicate what particular entries will always need to be made in such a case (at a minimum they will include “dummy” Forms 13, 14, 16, 40, 41, 42, 51 to 54 and 58). There is no requirement that the dummy return be audited, or be certified by an actuary: the Inland Revenue will rely on the company’s statement on its tax return, and will obviously expect the figures in the deemed return to reconcile with, or be reconciled with, figures in the company’s Companies Act accounts for the same period.

217. The making of the dummy return is to make the period for which it is made a “period of account” of the transferor. This is important because without a periodical return a company does not have a period of account, and it is by reference to periods of account and not accounting periods that much of the life assurance company tax provisions operate. In the case of a company carrying on life assurance business the “account” mentioned in the definition of “period of account” in section 832(1) ICTA is the periodical return, not the Companies Act accounts.

218. Section 444AA(3) deals with the case where there is an actual periodical return for a period ending after the transfer, that return is ignored in favour of the deemed return required by subsection (2).

219. Paragraph 16(2) gives the start date. It applies to transfers occurring on or after 1 January 2003 unless the start date of the accounting period ending with the transfer (in accordance with section 12(7A) ICTA) began before 1 January 2003.

Paragraph 17: charge on transferor retaining assets

Background

220. The Inland Revenue has seen cases where a company transfers its entire long-term business under a Part 7 transfer (or its predecessors) but where there are surplus assets of the L-TIF which the transferee does not require. What the transferor does is simply to leave an amount of assets behind and cease to carry on insurance business.

221. This is of no particular tax consequence if what is left behind represents undistributed surplus of the transferor, as the amounts involved will have been taken into account for tax purposes through the normal mechanisms of section 83 FA 1989. But if what is left behind represents assets where any excess of their market value over book value was not taken into account for tax purposes through the section 83 mechanism, then that store of value may never come into charge. It should, however, not be inferred from this that no charge will arise in a case where the transfer took place before 1 January 2003 – the point here is that with the enactment of section 444AA (see notes on paragraph 16 of Schedule 33) arguments based on the fact that there was no periodical return for the period will no longer be available.

Detail

222. Paragraph 17(1) inserts a new section 444AB into ICTA.

223. Section 444AB(1) gives the case. It is where immediately after a transfer of long-term business as a result of an insurance business transfer scheme, the transferor ceases to carry on long-term business but still holds assets which were L-TIF assets immediately before the transfer. Any assets which the company holds on trust for the transferee (e.g. assets which could not be transferred under the scheme of transfer because they are situated outside the UK) are ignored - section 444AB(10). Note that it is irrelevant that the company may continue to carry on general insurance business after the transfer in the case of a composite.

224. Section 444AB(2) is the operative rule. It imposes a charge under Case VI on the company for its first accounting period to begin immediately after the transfer. An accounting period will have ended with the transfer by virtue of section 12(3)(c) ICTA (cessation of trade) and a new one begun immediately after.

225. Section 444AB(3) and (4) give the alternative amounts to be brought into account. Section 444AB(3) provides that if a company is an “actual Case I” company for the accounting period ending with the transfer, then the taxable amount brought into account is the entire “previously untaxed amount” (defined in section 444AB(5) - see below). A company is “actual Case I” if it is a pure reinsurer within section 440B ICTA, or if the company has assessed itself on the basis that the I minus E basis does not apply to it, whether as a result of a determination under paragraph 84(5) Schedule 18 FA 1998 or

otherwise. The Inland Revenue will not make a determination under paragraph 84(5) simply to ensure that the whole amount under this section is brought into account, if it would not otherwise do so.

226. Section 444AB(4) gives the amount in the more usual case where a company is subject to the I minus E basis of taxation. In such a case, it is only the profits of its pension, ISA, life reinsurance or overseas life assurance businesses which are charged to tax using a Case I computation, so the part of the section 444AB(2) taxable amount, the previously untaxed amount, is the “non-BLAGAB fraction”. The meaning of non-BLAGAB fraction is given by section 444AB(9) and means the fraction:-

$$\frac{\text{liabilities transferred other than BLAGAB}}{\text{liabilities transferred}}$$

227. Section 444AB(5) defines the previously untaxed amount. The starting point in subsection (5)(a) is the fair value of the former L-TIF assets that were not transferred. “Fair value” here, as in section 83 FA 1989 (see paragraph 47 above), has the normal accountancy meaning such as that given in Chapter 2 Part 4 FA 1996 (loan relationships) and Schedule 26 FA 2002 (derivative contracts) – section 444AB(6).

228. However the starting point figure is reduced to the extent it can be shown that the retained amounts must have come from undistributed surplus. This is done by limiting the amount previously untaxed to the excess of two figures – section 444AB(5)(b).

229. The first figure is the fair value of the company’s L-TIF assets (broadly their Form 13 value, but without regard to admissibility restrictions) immediately before the transfer. The second figure is the relevant L-TIF liabilities immediately before the transfer. Section 444AB(7) defines the relevant L-TIF liabilities. This means the figures which would have been shown in Form 14 column 1 lines 14 (mathematical reserves) and 49 (other liabilities), if a periodical return had been drawn up for a period immediately before the transfer. The excess represents the difference between the fair value of the assets immediately before the transfer and their book value, and thus the store of value that has not been brought into account in the revenue account.

230. Example

A company transfers its business. Immediately before the transfer its assets were valued in Form 13 (or would have been so valued if one had been drawn up to the date of the transfer) at £100 million, and for the sake of simplicity it is assumed that this is their fair value. The entries at lines 14 and 49 of Form 14 would have been £75 million.

The fair value of the assets left behind is £10 million.

As the £10 million (the section 444AB(5)(a) figure) is less than the £25 million section 444AB(5)(b) figure, the previously untaxed amount is £10 million.

If the assets left behind has been valued at £30 million, the previously untaxed amount would be £25 million.

The use of “fair value” rather than simply “value” here (which by virtue of section 431(2) would mean the Form 13 value) is to prevent a company converting its to-be-retained assets into inadmissible assets, such as gold, immediately before the transfer.

231. Section 444AB(8) deals with the case where the liabilities transferred under the transfer scheme exceed the value of the assets so transferred. Whether there is such an excess is judged from the entries in the regulatory return of the transferee. In such a case the excess is deduct from the relevant pre-transfer liabilities.

232. “Insurance business transfer scheme” is defined in section 444AB(11) to mean both:

- a scheme falling within section 105 FSMA, including an excluded scheme falling within Case 2, 3 or 4 of subsection (3) of that section, and
- a scheme falling outside it as a result of failing to meet the condition in section 105(1)(b).

This is the same definition as is used in section 444AA – see paragraph 214.

233. Paragraph 17(2) gives the commencement date. It applies to transfer schemes taking place in a period of account (including a deemed one by virtue of section 444AA) of the transferor beginning on or after 1 January 2003.

Paragraph 18: modifications of section 83 FA 1989

Background: section 444AC

234. Where there is a transfer of life assurance business, the transferee assumes the liabilities to policy holders previously owed by the transferor. These liabilities are transferred by operation of law by a Court Order under Part 7 FSMA. Usually the consideration for the transfer of liabilities is the transfer of an amount of assets by the transferor. In the transferee's revenue account on Form 40 drawn up for the period first ending after the transfer, there will often be an entry in line 15 (other income) of Form 40. The description of this item in the note coded 4002 required by instruction 2 of Form 40 (and see paragraph 14.1(10)(b) of Appendix 9.2 IPRU (INS)) will usually refer to it as the fund brought forward from the transferor. Where the amount so described is equal to the liabilities assumed, then inclusion of the amount in section 83(2) as a trading receipt gives the right answer as it ensures that the taxable profit for the period is equal to the surplus for the period as shown on Form 58 line 35 (subject to any other adjustments required by tax law). Exclusion of the fund brought forward figure would result in a wholly artificial loss unrelated to the figure of surplus.

235. However, where the value of the assets transferred to the transferor exceeds the liabilities assumed, then it is likely that the excess represents surplus of the transferor that has already been subject to tax. Accordingly such amounts are not to be taken into account again by the transferee.

Detail

236. Paragraph 18(1) inserts a new section 444AC into ICTA

237. Section 444AC(1) gives the case. Again, the section applies where there is a Part 7 transfer.

238. Section 444AC(2) deals with the case described in paragraph 234 and 235. It looks to see if there is an excess of one amount over another. The first is the elements of the transferee's line 15 figure representing the transferor's L-TIF (defined by section 444AC(3)). The second is the amount of liabilities assumed from that transferor. Any excess is excluded from section 83(2)(d) FA 1989 – see also section 83(2B)(b) FA 1989.

239. Section 444AC(3) defines the term “the elements of the transferee’s line 15 figure representing the transferor’s L-TIF”. It is simply the amount in line 15 that represents the transferor’s fund carried forward in the period of account ending with the transfer.

Background: section 444AD

240. It may happen that where there is a transfer of business, the transfer of assets will trigger section 83(2B) FA 1989 (see paragraph 46 above). This will apply if the assets represent amounts which have not been reflected in the revenue account of the transferor – they will usually be amounts that would have been reflected in Form 14 line 51 of any periodical return of the transferor drawn up for a period immediately before the transfer. Where those assets come to be held by the transferee as assets of its L-TIF, but in circumstances such that the value of the assets is not brought into account in the revenue account of the transferee, or treated as a transfer to the L-TIF so as to be recognised on Form 58 line 34, then there is a risk of double taxation, as the bringing into account of amounts on line 13 of Form 40 may have the effect of taking the same amount of value of the assets as has been taken into account by virtue of section 83(2B) into account again. Section 444AD aims to prevent this double taxation.

Detail

241. Paragraph 18(1) also inserts section 444AD into ICTA.

242. Section 444AD(1) gives the case. Again, the section applies where there is a Part 7 transfer.

243. Section 444AD(2) gives the operative rule. If both parties elect, then section 83(2B) FA 1989 is disapplied to the amount specified in subsection (4).

244. Section 444AD(4) gives that amount. It is the excess of two figures. The first is the fair value of the L-TIF of the transferee immediately after the transfer. “Fair value” is defined in section 444AD(5) and has the normal accountancy meaning such as that given in Chapter 2 Part 4 FA 1996 (loan relationships) and Schedule 26 FA 2002 (derivative contracts). The second is the amount brought into account on line 15 of Form 40 as represents the assets transferred under the transfer for the first period of account ending after the transfer. It is

irrelevant that any part of the amount brought into account is excluded from tax by section 444AC(2).

245. Section 444AD(3) gives the details of the election under subsection (2). It is irrevocable, and must be made within 28 days of the transfer (or by 30 September 2003 if later – paragraph 18(4)). A further condition, similar to those for joint elections in section 200 Capital Allowances Act 2001, is that a copy of the election notice must accompany the transferee's first tax return after the transfer. The normal rules in the CT Self Assessment legislation in Schedule 18 FA 1998 about claims and elections do not apply to this election.

Background: section 444AE

246. Section 83ZA FA 1989, inserted by paragraph 3 Schedule 33 (see paragraph 58 onwards), deals with the tax treatment of "contingent loans". Section 444AE covers the treatment where contingent loans are transferred in the course of an insurance business transfer scheme.

Detail

247. Section 444AE(1) gives the case. Again, the section applies where there is a Part 7 transfer.

248. Section 444AE(2) is the operative rule. Where a company transfers a contingent loan it owes to another company in the course of an insurance business transfer scheme, otherwise than by novation, the transferor is treated as having repaid the loan and the transferee as having received one. "Contingent loan" here has the meaning it has in section 83ZA, that is a loan which on receipt is brought into account in the company's revenue account. An insurance business transfer scheme can have effect to transfer liabilities under a court order without them being novated (which requires the consent of the creditor).

Detail: paragraph 18 generally

249. Paragraph 18(2) inserts a definition of "brought into account" into section 431(2), giving it the meaning it has in section 83A FA 1989 - brought into account in the revenue account (Form 40).

250. Paragraph 18(3) gives the general commencement rule. All three new sections apply for periods of account beginning on or after 1 January 2003.

Paragraph 19: Transfers of business: unused allowable losses

Background

251. Section 211 TCGA modifies section 139 of that Act, and allows a no gain/no loss transfers of assets where they are transferred as part of a Part 7 transfer. But if the transferor has allowable losses within the meaning of that Act which it cannot use due to an insufficiency of gains accruing before the transfer, the losses may be stranded. It may under existing law be possible to generate gains to mop up the losses before transfer by a “bed and breakfast” type transaction, but that may be costly, and may not be possible after the changes made by paragraph 14 of Schedule 33 (see paragraph 177 onwards). Following representations made by the industry the Government has decided to permit allowable losses to be carried over in the exceptional case of a Part 7 transfer.

252. There is an existing Extra-Statutory Concession (“ESC”) C29 which permits a carryover of a restricted category of allowable loss. These losses are ones which were transformed from being general annuity business (“GAB”) Case VI losses into allowable losses by paragraph 17 Schedule 7 FA 1991, when GAB was abolished as a separate category of business. The new legislation will subsume these losses and the ESC will cease to apply.

Detail

253. Paragraph 19(1) inserts new section 211ZA into TCGA.

254. Section 211ZA(1) gives the case. It applies where there is a Part 7 transfer and the transferor has “relevant unused losses”. Section 211ZA(2) defines that term. There are relevant unused losses if BLAGAB allowable losses accrued to the transferor in the accounting ending with the transfer or any earlier accounting period of it while it was chargeable to corporation tax, and the losses are not deducted from gains accruing in any of those periods.

255. Section 211ZA(3) sets out the operative rule where the whole of the transferor’s BLAGAB is transferred. The relevant unused losses cease to be available to the transferor and become available to the transferee.

256. Section 211ZA(4) shows how the losses are treated in the hands of the transferee. They are treated as BLAGAB allowable losses of the accounting period in which the transfer falls, but they cannot be

deducted from any chargeable gains accruing to the transferee before the transfer - section 211ZA(5). For the purposes of section 210A (ring-fencing) inserted by paragraph 13 of Schedule 33 – see paragraph 154 onwards, the shareholders’ share of the transferred losses is the proportion of them given by the circumstances of the transferor - section 211ZA(6).

257. Section 211ZA(7) applies if only part of the transferor’s BLAGAB is transferred. In such a case, the relevant unused losses accruing to the transferee are such amount as is appropriate in the case. This echoes the rule in section 213(7) where losses on deemed disposal of certain holdings in unit trusts and OEICs are carried over.

258. If there is more than one transferee of the transferor’s BLAGAB, section 211ZA(8) requires amount of the relevant unused losses to be transferred to each transferee to be such as is appropriate.

259. Section 211ZA(9) provides for the Special Commissioners to adjudicate on questions of what is appropriate in subsections (5) or (6). This is similar to the rule in section 213(8).

260. Section 211ZA(10) contains a definition of “BLAGAB allowable losses” - it means allowable losses referable to the BLAGAB.

261. Paragraph 19(2) gives the commencement rule. It has effect in relation to Part 7 transfers taking place on or after 1 January 2003 (irrespective of when the respective accounting periods began). This is because, despite being retrospective, it is a relieving section.

Paragraph 20: adjustments of opening and closing liabilities

Background

262. In a number of provisions relating to the taxation of life assurance companies, apportionments are made by reference to the mean of the opening and closing liabilities of a period of account. And in some cases opening and closing asset values are used, and in section 432A(6) ICTA the opening and closing amounts of the “investment reserve”.

263. “Liabilities” and “value” have meanings taken from the periodical return (the FSA return) made and deposited under Rule 9.3 IPRU (INS) – section 431(2). “Investment reserve” is defined in section 432A(9B) ICTA (but see notes on paragraph 23 of Schedule 33). “Opening” and “closing” are also defined in section 431(2) to mean the figures at the

beginning and end of a period of account. They do not mean at the beginning and end of an accounting period, if different. Where an accounting period is not coincident with a period of account (as for example where a Part 7 transfer takes place before the end of a period of account) the opening and closing figures in relation to the accounting period are the figures for the period of account in which the accounting period falls.

264. Problems arise where there is a Part 7 transfer part way through a period of account. Take this example:-

A period of account starts on 1 January when the company has

BLAGAB liabilities 1000

Pension liabilities 1000

On 30 September it transfers pension liabilities of 500 in a Part 7 transfer

On 31 December it has

BLAGAB liabilities 1000

Pension liabilities 500

Assume that the company earns a 10% return on its assets (whose amount is equal to its liabilities) evenly throughout the year. It would be expected that it would have income of 100 on its BLAGAB assets, and 87.5 on its pension assets (1000 @ 10% for 9 months; 500 @ 10% for 3 months)

Section 432A requires the mean of the opening and closing liabilities of each category as a fraction of the total to be applied to the total income.

BLAGAB mean is $(1000 + 1000)/2 = 1000$

Pension mean is $(1000 + 500)/2 = 750$

Total mean is $(2000 + 1500)/2 = 1750$

Thus BLAGAB income is $1000/1750 \times 187.5 = 107$

Pension income is $750/1750 \times 187.5 = 80.5$

QNEED

Similar distortions arise where the transferee acquires liabilities and assets in a Part 7 transfer part way through a period of account. Paragraph 18 is intended to remove these distortions.

Detail

265. Paragraph 20(1) inserts subsections (2ZA) to (2ZD) into section 431 ICTA.

266. Section 431(2ZA) gives the case. It is where there is a Part 7 transfer.

267. Section 431(2ZB) applies where for a transferor, a transfer takes place otherwise than on the last day of a period of account. This will be the case where a part transfer takes place during the period of account, or where a whole transfer takes place and a periodical return is made for a period ending after the transfer.

268. In this case a fraction (A/C) is applied to the opening liabilities, opening values of assets and opening amount of the investment reserve, so far as they relate to the transferred business.

269. Section 431(2ZC) applies where for a transferee, a transfer takes place otherwise than on the first day of a period of account. In this case a fraction (B/C) is applied to the closing liabilities, closing values of assets and closing amount of the investment reserve, so far as they relate to the transferred business.

270. Section 431(2ZD) gives the definitions of A, B & C.

- A is the number of days from the beginning of the period of account to the transfer
- B is the number of days from the transfer to the end the period of account
- C is **half** the number of days in the period of account.

Apply this to the example above:-

A period of account starts on 1 January 2003 when the company has

BLAGAB liabilities 1000

**BOARD OF INLAND REVENUE
RESOLUTION 44**

**FINANCE BILL 2003
CLAUSE 169
SCHEDULE 33**

Pension liabilities 1000

On 30 September it transfers pension liabilities of 500 in a Part 7 transfer

On 31 December it has

BLAGAB liabilities 1000

Pension liabilities 500

Assume that the company earns a 10% return on its assets (whose amount is equal to its liabilities) evenly throughout the year. It would be expected that it would have income of 100 on its BLAGAB assets, and 87.5 on its pension assets (1000 @ 10% for 9 months; 500 @ 10% for 3 months)

Section 432A(2ZB) requires an adjustment to the opening figures for the transferred business.

A is 273

C is 182.5

So

opening BLAGAB liabilities are 1000 (as none transferred)

opening pension liabilities 500 (not transferred) plus

$500 \times 273/182.5 = 748$ (total 1248)

the mean of the opening and closing liabilities of each category as a fraction of the total is then applied to the total income.

BLAGAB mean is $(1000 + 1000)/2 = 1000$

Pension mean is $(1248 + 500)/2 = 874$

Total mean is $(2248 + 1500)/2 = 1874$

Thus BLAGAB income is $1000/1874 \times 187.5 = 100$

Pension income is $874/1874 \times 187.5 = 87.5$

QED

271. Paragraph 20(2) gives the commencement. It applies to Part 7 transfer schemes taking place on or after 1 January 2003 unless the accounting period of the transferor ending with the transfer began before that date.

Paragraph 21: reinsurance of BLAGAB risks

Background

272. Section 442A ICTA was enacted in Finance Act 1995 as part of the reform of reinsurance business. It was designed to stop avoidance of tax on the investment return accruing for policy holders and shareholders under the I minus E basis. By reinsuring the investment risk in a life assurance policy the company was replacing the investment return it could otherwise earn on the amount of its premiums paid to the reinsurer with a reinsurance recovery when the policy matured that was arguably outside the I minus E charge, depending on the view taken of the effect of section 547(2) ICTA.

273. Section 442A provided for the imputation of an investment return on the reinsurance premium. The detailed rules are in regulations 3 to 10 of the Insurance Companies (Reinsurance) Regulations 1995 (SI 1995/1730). The question that arose was whether section 442A works properly when a reinsurance contract is transferred in a Part 7 transfer.

274. The effect of the transfer on section 442A appears to be this. If the arrangement was within section 442A when it was made by the transferor, income will have been imputed period by period over the life of the arrangement. An imputation will be made for the period ending with the transfer, but there will be no final reckoning under regulations made by virtue of s 442A(4) because that is not the final period during which the policy or contract (which means here the underlying policy) is in force.

275. The transferee is a company which is reinsuring a risk in respect of a policy -section 442A(1) - so by virtue of that subsection an investment return is to be attributed to it, but “over the period of the reinsurance arrangement.” Is that to be taken to mean the period of the reinsurance arrangement so far as it is an arrangement between the transferee and the reinsurer? That would give a sensible answer with the result that an investment return may be attributed to the transferee over the period it is a party to the arrangement.

276. But when it comes to the calculation of the investment return under section 442A(3) and the regulations, the calculation should take into account payments made by the transferor as well as the transferee, but the singular reference to “the company” suggests that only payments made by the transferee may be taken into account. Similarly with payments made to the “company” in section 442A(3)(b) and the return accruing to “the company” in section 442A(3)(c).

277. However section 442A(4) seems fine as it stands – the amount of the final adjustment should be calculated by comparing the profit over the whole period with the imputed amounts over that period, irrespective of who was party to the arrangement.

278. Paragraph 21 is designed to clear up these issues.

Detail

279. Paragraph 21(1) paves the way for amendments to section 442A.

280. Paragraph 21(2) amends section 442A(1) to make it clear that the imputation to any company, transferor or transferee, is only operative for the period during which it is the cedant.

281. Paragraph 21(3) inserts a new section 442A(3A). This provides that where there is a transfer of a reinsurance arrangement either by novation or in a Part 7 transfer (and the High Court has recently confirmed that a reinsurance contract may be transferred as part of a Part 7 transfer – *Re WASA International Insurance Co* (2002) EWHC 2698 (Ch)) then references to “the company” in subsection (3) are to the transferee, the transferor and any earlier transferor.

282. Paragraph 21(4) amends section 442A(4) by omitting the words “to the company” so that the final period adjustment is calculated by reference to all earlier imputed amounts.

283. Amendments to reflect these changes will be required to SI 1995/1730, and amending regulations will be laid as soon after Royal Assent as possible.

284. Paragraph 21(5) gives the commencement rule. It applies to transfers of reinsurance arrangements taking place on or after 1 January 2003.

Paragraph 22 carry over of Case VI losses

Background

285. Under section 444A(3) ICTA there is an unrestricted carry forward of Case VI losses relating to pension & ISA business and life reinsurance business, and of certain overseas life assurance business losses. It has always been anomalous that these losses, which are entirely matters to do with the shareholders' interest in the life assurance business, can be carried over like the other matters which are predominantly policy holder matters – as the rationale for the tax neutrality of Part 7 transfers is that it is the policy holder interest in the business remains unchanged.

286. However there are circumstances where trading losses can be carried over generally, and not just in life assurance business, where a trade is transferred from one company to another – in section 343 ICTA. This section applies to any Case I losses of a life assurance company on the occasion of a Part 7 transfer where the conditions in the section are met (mainly that there is a 75% commonality of shareholder interest both before and after the transfer).

287. Accordingly the ability of a company to carry over a Case VI loss from any of the categories of life assurance business is to be subject to the same conditions as apply to Case I losses.

Detail

288. Paragraph 22(1) paves the way for amendments to section 444A ICTA.

289. Paragraph 22(2) amends section 444A(3) (which relates to the carry over of Case VI losses) by making it a condition of its operation that the conditions of section 343(1)(a) and (b) are satisfied. Those conditions are that at any time in the two years after the transfer of a business a 75% interest in the trade is held by the same persons as had such an interest in the period of a year before the transfer and that the trade is not carried on in that period by a company not within the charge to CT.

290. Paragraph 22(3) inserts a new section 444A(3ZA). This provides that in any case where a loss is available to carry over in accordance with the revised section 444A(3), the other provisions of section 343

and 344 ICTA apply. The main effect of applying those provisions is that:

- there is a stand in shoes carry over of capital allowances – section 343(2)
- carry over is restricted where the amount of “relevant liabilities” exceeds the market value of “relevant assets” – section 343(4) and 344(5) to (12).
- “relevant assets means assets of the transferor not transferred plus any consideration given to the transferor other than the assumption of liabilities. Thus in a Part 7 transfer, it is likely that “relevant assets” will simply mean the assets retained.
- “relevant liabilities” are liabilities outstanding not transferred to the transferee.
- securities (which for this purpose is restricted to shares) transferred are treated for the purposes of section 731 ICTA as sold and repurchased – section 343(5)
- where there is a subsequent transfer by the transferee, the two or more transfers are looked at together – section 343(7)

But the streaming rule in section 343(8) is applied here only to the transferor. The transferee may set any Case VI losses inherited from the Case VI profits of the same category of business.

291. Paragraph 22(4) gives the commencement rule. It applies to a Part 7 transfer taking place on or after 1 January 2003, unless the accounting period of the transferor ending with the transfer began before that date, or the transferee’s accounting period which includes the transfer began before that date.

Paragraphs 23 to 26: Meaning of “investment reserve” etc. and other loan relationships changes

Background

292. This paragraph collects together a number of amendments to references to the loan relationships legislation.

Detail

293. Paragraph 23 restores the definition of “investment reserve” to section 431 from section 432A(9B), as it will now be used in more than one section of the Act. It also amends the meaning of the term to restore the deduction of money debts as a whole (reversing the unnecessary amendment to section 432A(9B)(b) made by paragraph 46 Schedule 25 FA 2002), and makes it clear that “liabilities” in the definition only includes actuarially estimated liabilities.

294. Paragraph 24 makes a similar change to section 432A(9A) (meaning of net value in apportionments)

295. Paragraph 25 makes a further similar change to the OLAF rules in Schedule 19AA

296. Paragraph 26 gives the commencement rule for the three previous paragraphs - periods of account beginning on or after 1 January 2003.

Paragraphs 27 and 28: rationalisation of interpretation provisions

Background

297. The Finance Act 1989 made major changes to the taxation of life assurance business. Hitherto, the provisions of the Taxes Act dealing with insurance business had been consolidated into Chapter 1 Part 12 of ICTA, in sections 431 to 458. Sections 82 to 90 FA 1989 added substantially to that corpus of law, and used many specialised terms that were defined in Chapter 1 Part 12 ICTA, in section 431(2). But there was no explicit read across to that Chapter. Instead readers were left to assume that the undefined terms would be given the same meanings as in section 431(2).

298. Schedule 33 adds a number of new provisions into FA 1989 and it was thought more helpful to readers if they could be sure that all terms used in sections 82 to 90 FA 1989 that were also defined in Chapter 1 Part 12 ICTA could be seen explicitly to have the same meanings.

Detail

299. Paragraph 27 amends section 84(2) and (3) FA 1989 which defines “straddling period” for the purposes of section 84 itself and of sections referred to in section 84(1). But because section 84(1) defines “basic life assurance and general annuity business” as in section 431(2), but

only for the purposes of sections 85 to 89, it is unnecessary in view of the change made by paragraph 28 of Schedule 33 and is repealed. So instead of referring to the sections mentioned in subsection (1), subsections (2) and (3) mention them explicitly.

300. Paragraph 28 inserts a new section 90A into Finance Act 1989. This section provides that Chapter 1 Part 12 ICTA will be the dictionary for any terms used in sections 82 to 90 that are also used in that Chapter. As a result, section 83(6A), the second sentence of section 83A(2) and a definition in section 89(7) are repealed.

301. Paragraph 29 inserts new section 214BA into TCGA. This performs the same function for Chapter 3 Part 6 TCGA as the new section 90A FA 1989. As a result, words in section 204(4), section 211(1A), words in section 212(7), paragraph 10(1) Schedule 7AD and words in paragraph 1 Schedule 7B TCGA 1992 are all repealed.

BACKGROUND

Background: life assurance company taxation

General

302. In most cases, a company carrying on life assurance business is charged to corporation tax otherwise than in accordance with the provisions of Case I of Schedule D, the Case which would naturally apply to the profits of a trade, which all insurance is. Instead the charge is on income falling within the other cases (III, V & VI) of Schedule D and Schedule A, and the chargeable gains, with relief for expenses of management. This is the I (income and gains) minus E (expenses) basis.

303. The rationale for charging a company on this basis is that it taxes, in one sum, both the income (and gains) that accrue for the benefit of policy holders (to be paid out to them in their claims) and those that are retained by the company as the profit of its business. A Case I computation on the other hand would allow a deduction for the annual increase in the liability of the company to its policy holders which would more or less match the amount of income (and gains) accruing for the policy holders.

304. That the I minus E result performs this dual function has been recognised in various ways over the years by legislation. The principle

of the I minus E system was also recognised when a charge to tax on policy gains was introduced in 1968 (now to be found in Chapter 1 Part 13 ICTA). Until 1972/73 this was a charge to surtax only. From 1973/74 in the case of an individual the charge was to income tax at the excess of the higher and additional rates of tax over the basic rate, and consequently there was no charge at the basic rate of income tax, in recognition that tax had already been charged by proxy on the policy holder through the I minus E mechanism. Since 1940 the rate of income tax, and then corporation tax, on that part of the I minus E result which could be said to represent the policy holders' share was charged at what was known as the "pegged rate" – a rate of 7s 6d in the £ (37.5%) – whenever the standard rate of income tax, and then the rate of corporation tax, exceeded that figure. This "pegged rate" disappeared in 1986 when the rate of CT fell below the basic rate of IT.

305. For some years after 1973 the policy holders' share of chargeable gains was distinguished from the policy holder income to be charged at a different rate – the last manifestation of this rule being in section 435 ICTA .

306. In 1989 the special rate of CT on the policy holders' share of profits was restored. Section 88 Finance Act 1989 specifically provides that the policy holders' share of the "relevant profits" (a phrase defined in section 88(3) to mean essentially the I minus E result) is to be charged at a rate of CT deemed to be the rate at which IT is charged at the basic rate. Section 89 Finance Act 1989 explains how to calculate the policy holders' share. This is done by taking what would be the Case I profit if the company were so charged, adjusting it for distributions from UK companies (which are included in a life insurers' Case I profit by virtue of section 434(1) ICTA – but not included in relevant profits) and deducting the adjusted amount from the relevant profits. This mechanism explicitly recognises that the shareholders' share of the I – E result is equivalent to its trading profit.

Case I profits

307. Although the profits from life assurance made by most companies carrying on life assurance business are computed on the I minus E basis - see paragraph 303, it is still necessary to compute the profits of all or parts of their life assurance business using the provisions of Case I of Schedule D (computation of profits of a trade) for various purposes, including:

- section 89 Finance Act 1989, to determine how much of the I minus E profits are shareholders' profits (charged at normal corporation tax rates) and how much are policyholders' profits (charged at reduced rates of corporation tax equal to the basic and lower rates of income tax) - see paragraph 107 concerning changes to these rules.
- section 76(2) ICTA 1988, to set a floor below which any relief for management expenses cannot be allowed to reduce the I minus E profits- see paragraph 129 concerning changes to these rules
- loss relief - section 434A(2) ICTA
- assessment in those rare cases, including pure reinsurers by virtue of section 439A ICTA , where the company is assessed on an actual Case I basis rather than the I minus E basis
- sections 436, 439B & 441 ICTA to calculate the profits of pension, ISA, life reinsurance and overseas life assurance business.”

308. The Case I computations of life assurance companies are not based, as those of other companies are, on the profit disclosed in the accounts prepared for the purposes of the Companies Act 1985. Instead they are prepared using as their starting point the surplus disclosed in the FSA return. All life insurance companies are required to draw up a “revenue account” for the purposes of their FSA return. The requirement is in rule 9.3 of the IPRU(INS) in which they record investment income and gains, premiums, claims and expenses. Sections 82 to 83A FA 1989 set out the special rules that apply when making the Case I computation, and are based on the requirements of the periodical return.

309. The rules in section 83(2) Finance Act 1989 provide, in effect, that it is only the investment gains or losses as disclosed in the revenue account which are to be included as receipts in Case I computations, for the period in which they are so disclosed (and no other). A characteristic feature of most funds conducting with-profits business (business where the policy holder may participate in the established surplus arising to the company - usually by way of bonus) is that for the purposes of determining surplus, assets are not taken into account at market value (as is generally required for the purposes of testing

solvency) but may, by election, be taken into account in accordance with their book value. The effect of this is that appreciation or depreciation in asset values is only recognised indirectly in the Form 40.

310. If there is no election to use book value (which is the case with companies writing only non-participating including linked business) the revenue account in Form 40 can be seen as a form of semi-cash flow statement into which premiums, investment income and gains (including unrealised gains) are shown as credits and expenses and claims paid as debits, the balance being the “closing fund” which in such a case would have a value equal to the market value of the company’s assets held in connection with its life assurance business.

311. But if there is an election to use book value (which is almost always the case with companies writing only participating business) companies are able to defer recognition of investment gains and asset appreciation (in terms of increases in market value) as they arise. This facility to use book value is part of the smoothing mechanism under which with-profits business has traditionally operated in the UK. Companies do not wish to distribute as bonuses (and, if not mutual, dividends) all the profits from investment income and gains made in a year as some may need to be kept back to bolster the profits of a later less prosperous year.

312. But it is an unusual company that can meet its policy holders’ reasonable expectations as to bonuses, and thus its shareholders’ expectations of dividends, purely from investment income. So in most cases the company recognises some or all of what is described in Form 40 “increases in the value of non-linked assets brought into account”: whatever amount is needed to cover such part of its claims and bonuses as cannot be met from investment income and premiums less expenses and still leave a surplus for shareholders. It is only when this act of recognition of book value changes takes place that the amounts, as entered on Form 40 (at line 13), are “brought into account” within the meaning of section 83(2) FA 1989. If the company wants to pay more bonuses, and, accordingly, make bigger distributions to shareholders (because under the constitutions of most companies writing participating or with-profits business, distributions to shareholders are limited to a fraction of the profits declared or distributed as bonuses to policy holders – the usual figure is one-ninth, so that the profits are divided 90:10) it must recognise a larger amount at Form 40 line 13 to fund

them. But the result of this smoothing mechanism is that a lot of gains may accumulate untaxed (for Case I purposes).

313. The difference between book and market value (sometimes erroneously called the “investment reserve”) can be found in the entry in Form 14 line 51.) it must recognise a larger amount at Form 40 line 13 to fund them. But the result of this smoothing mechanism is that a lot of gains may accumulate untaxed (for Case I purposes) in what has come to be known as “the investment reserve”. The value of that “reserve” – the difference between market value and book value, can be seen from the entry in Form 14 line 51.

314. It has become increasingly apparent that companies have been looking for ways to extract untaxed gains (or rather an amount of assets representing them) in such a way that the gains do not have to be recognised for tax purposes by passing amounts through the revenue account.

315. Companies have also realised that if they use assets (including cash) to pay expenses or to discharge liabilities in a way that is not reflected in the revenue account and if those expenses or payments would not fall to be deducted in a Case I computation if they were shown in the revenue account, then this is tantamount to getting an unwarranted deduction for them, because the amount needed to be recognised in line 13 to balance the surplus is reduced.

316. Many of these manoeuvres (but not all of them) involve the company transferring its long term business to another company or companies under a scheme approved by the Court in accordance with Part 7 FSMA (previously Schedule 2C ICA). Many such schemes are driven by commercial considerations, such that the extraction of untaxed gains is a fortunate by product, but it is also not difficult to arrange an intra-group transfer specifically to enable extraction of untaxed gains.

317. Where there is a Part 7 FSMA transfer of business, then normally all the assets and all the liabilities of the transferor are passed over to the transferee. Where there is at the date of the transfer an excess of market value of assets over book value, then assets representing in value the amount of that excess will normally be transferred so as to be a similar excess of the transferee. Other assets of the transferor held and disclosed in the L-TIF of the transferor will equally be shown as arising in the fund of the transferee, usually by being reflected in line 15 of Form 40.

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318. Where assets move from the transferor to the transferee without being reflected in the revenue account of both companies, then nothing has been lost: changes in book value of those assets as recognised in Form 40 line 13 of the transferee will still emerge in the ordinary course of events. But where assets equal to the market/book excess of the transferor are either retained by the transferor, or are transferred to the transferee in such a way that they do not become market/book excess of the transferee, then the opportunity to bring the gains into the revenue account of the transferee is forever lost.