

# Agreed minutes (27/7/06)

## Notes of Meeting 29 June 2006

### Apportionment working group

Location: ABI HQ at 51 Gresham Street, London EC2V 7HQ

#### Present:

Graham Barrett	HMRC
Jeremy Tyler	HMRC
Carol Johnson	HMRC
Mike Chadwick	Friends Provident
Nigel Collard	L&G
Jeremy Hart	Axa
Keith Johnson	Scottish Equitable
Andrew Todd	Aviva
Kate Webster	ABI
Carolyn Woodroffe	ABI
Phil Lewis	KPMG
Roy Lonergan	PWC

## 1. Introduction

1. Jeremy Tyler introduced the HMRC team. Graham Barrett who is retiring next week will be replaced by Richard Thomas at future meetings.

## 2. Givens

- 2.1 HMRC's policy objective is 100% apportionment, reflecting the underlying economic reality of the business.
- 2.2 It was agreed that the discussions in this strand would extend to further consideration of investment reserves (as in 83YA) and inherited estates, as agreed earlier in the year. (logged as **Issues 14 & 15**)
- 2.3 **Issue 1:** Should the needs basis be retained for WP funds? Industry view is that the smoothing provided by needs basis, replicating commercial smoothing in with profits business, is still desirable, to avoid commercially mismatched results. But if it is 100% apportionment will not be achievable.
- 2.4 **Issue 2:** 100% apportionment of what? There is a difference between BLAGAB and GRB gains. But income may also be different since loan relationship capital movements usually go through line 13 of Form 40, or are taken to investment reserve if the company maintains one. Does the 100% apportionment objective require 100% on a common measure?
- 2.5 If a 'brought into account' basis was adopted for BLAGAB the benefit of indexation would be lost. Indexation goes some way to compensate for the fact that policyholders would have the benefit of the annual exemption if they held investments directly. Could this be compensated for by a reduction in the policyholder rate of tax?

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2.6 The industry view is that this is too complex an issue to tackle and unlikely to result in an industry consensus. Also that it strays into policy development, and therefore is more appropriate to the Treasury.

### 3 Assumptions

3.1 Any changes whilst being tax neutral overall will produce winners and losers. Proposals would need to be modelled in detail.

### 4. TCondoc - Approach 1 (paras 2.18-2.20: apply single rule (s432A) to whole business)

4.1 The ABI working party were unanimously against Approach 1:

- it would not allocate return between BLAGAB and GRB in line with commercial reality.
- it would give a very volatile Case VI profit because of the volatility of gains/loan relationship capital movements rather than a needs basis result based on transfers to Shareholders..
- it does not incorporate needs basis for with-profits Case VI calculations
- it would cause problems with the allocation of tax to policyholders sub-funds. The FSA requires that policyholders should be treated fairly. Increasingly this means companies are required to calculate tax on a sub fund basis.

4.2 **Issue 3:** If approach 1 is considered further the interaction of approach 1 with Case 1 losses this would need to be considered.

### 5. TCondoc – Approach 2 (paras 2.21-2.23: apply single rule (s432A) to separate funds)

5.1 Although the ABI working party recognised some benefits in approach 2 it had some major disadvantages:

- it does not incorporate needs basis for with profits Case VI calculations
- the FSA is more relaxed now on the location within a life company of regulatory capital. So, for example, one fund can support another. Under this approach there would be problems identifying the assets supporting a WP fund. As such it was quite likely to involve some degree of complexity to make it work.

5.2 HMRC said that it had had, from time to time, issues with groups taking an inconsistent approach to assets.

5.3 **Issue 4:** Given that there is no requirement to hold regulatory capital in a particular sub fund application of the inherited estate regulation on a sub fund basis could cause distortion.

5.4 **Issue 5:** The ABI wanted clarification of paragraphs 2.22 and 2.23.

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5.5 **Issue 6:** The pooling of shares for CG purposes would cause problems with a sub fund basis. Could there be pooling on a sub fund basis?

### **6. TCondoc - Approach 3 (paras 2.24 & 2.25: apply s432C to non profit funds; s432E (or other) to with profit funds)**

6.1 The ABI thought that approach 3 had the best potential to reflect commercial reality, on a sub fund basis. There were however some aspects they had concerns about, which led to discussion of a potential approach '3 ½'. For example,

- need to retain the realisation basis for BLAGAB in non profit funds;
- need to retain needs basis for with profits business

6.2 Adopting the needs basis for WPF would give a volatile BLAGAB result. Could 432A be retained for BLAGAB with the needs basis used for GRB investment return?

6.3 The ABI thought that although this would not balance on a year by year basis it would over time, apart from where there were structural mismatches such as when the allocation of bonuses to categories of business was not in accordance with the ratio of liabilities. This could possibly be dealt with by apportioning BLAGAB I &G in accordance with bonuses.

6.4 Issues of materiality may arise again, for example, where there is only a small amount of with profits business. (link to Question 5)

6.5 **Issue 7:** The ABI would prepare a paper outlining a modified version of approach 3, in the first instance as the basis for clarifying the industry preferred approach. As part of this process the modified approach would need to be modelled.

### **7. TCondoc – Approach 4 (paras 2.26 & 2.27 – current rules scaled up or down)**

7.1 The ABI said that although the approach was superficially attractive, as it could get closest to 100% apportionment, in practice it would be complex and uncertain especially where there was with profit business. Moving BLAGAB on to 1- needs, or moving GRB away from bonuses, would not reflect commercial reality

### **8. Other issues**

8.1 **Issue 8:** The ABI had no enthusiasm for the reclassification of liabilities classified as with profit liabilities in the FSA return, as non profit for tax (Question 2). Whether annuities in payment were with profits or not depended on the terms of the policy and the constitution of the company's with profits business. HMRC believed that, if annuitants were not entitled to participate in profits, then the liabilities should be treated as non profit.

8.2 Recent changes to the FSA return required liabilities to be assigned to product codes. Possibly there should be consultation with the FSA to ensure alignment?

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8.3 **Issue 9:** In the ABI's view the issue of pension term assurance was a question of the primacy of the 'A' Day definition (Question 3).

8.4 **Issue 10:** The ABI agreed with the proposition in Question 9, i.e. a return to the pre FA 2003 loss position for the Section 89(3) fraction.

8.5 **Issue 11:** On the question of the split of liabilities between PHI and BLAGAB for life policies with a critical illness element (Question 4) there were doubts that this was in fact possible, from a practical point of view. The ABI thought that this might be another area where clarification should be sought from the FSA.

8.6 **Issue 12:** The ABI did not like the proposal that income and gains on inherited estate should be treated as a separate category of business (Question 8).

8.7 **Issue 13:** Yes, the ABI wanted a deduction for deferred policyholder tax (Question 11) on the basis previously discussed with HMRC.

### 9. Next Meeting

9.1 This would be on 14 July<sup>1</sup>. The ABI would provide responses on the ground covered at this meeting plus responses to the question in the Condoc not yet covered.

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<sup>1</sup> Subsequently deferred to September