

**LIFE TCONDOC – LOSSES & GROUP ISSUES**

**MINUTES OF THE HMRC WORKING GROUP MEETING HELD ON WEDNESDAY 12 JULY 2006 AT 3 LOCHSIDE AVENUE, EDINBURGH**

**PRESENT**

Mike Chadwick	Friends Provident
Keith Johnson	Scottish Equitable
Andrew Todd	Aviva
Nigel Collard	Legal & General
Liz Punchard	Zurich
Matthew Taylor	Ernst & Young
Evelyn Stevenson	PwC
Peter Wright	Deloitte
Colin McHardy	HMRC (in the Chair)
Robert Baird	HMRC
Kate Webster	ABI
Carolyn Woodroffe	ABI

**1 INTRODUCTION**

- 1.1 HMRC introduced the meeting as the second meeting of the HMRC working group (“the Group”) to discuss issues arising from sections within Chapters 4 and 6 of HMRC’s Life Assurance Company Taxation Technical Consultative Document (“TCondoc”) of May 2006. HMRC advised that draft minutes of the previous meeting were only circulated to the Group yesterday. They appreciated that members may not have had sufficient time to review the document and provide any responses. The Chairman noted that members were welcome to provide responses to the minutes during the meeting today. ABI indicated that, given the limited time available for review, they would instead collate comments and send a single amended version to HMRC for consideration & agreement.

HMRC circulated a document detailing all the issues/points raised by the industry group in the previous meeting (“issues list”). They advised that this list would be updated after each meeting in order to help the Group keep track of progress on the various issues and any subsequent decision on them. HMRC referred to this list during the course of the meeting. HMRC were encouraged to circulate issues lists for all the TCondoc workstreams. HMRC indicated that this would be done.

## 2 **RELIEF FOR INTANGIBLES (ISSUE 22)**

- 2.1 HMRC advised that after consideration this issue is thought to be outside the scope of this Consultation. Therefore this point will not receive any further thought during this process. The industry representatives accepted this viewpoint.

## 3 **OBSOLETE LEGISLATION (ISSUES 23 & 24)**

- 3.1 HMRC advised that they believe these areas should be considered towards the end of the Consultation process once other matters have been considered and, hopefully, resolved. This would leave the Group in a better position to re-examine the legislation which is now obsolete and make suggestions for particular provisions to be repealed.

## 4 **S212 & ITS INTERACTION WITH OTHER PROVISIONS (ISSUES 17 – 19)**

- 4.1 The industry representatives outlined their concerns in relation to s212 TCGA 1992 as follows:

- The key issue with s212 TCGA 1992 in relation to a transfer of business is that the provision is effective when the transferee is a new company, but does not operate effectively when the transferee is a company with an existing life business. The Chairman noted that he has made a suggested amendment to the minutes of the previous meeting to that effect.
- In terms of the interaction of s212 TCGA 1992 with the CFC rules and offshore fund legislation, if an offshore fund does not pursue an acceptable distribution policy, then the tax charge is levied on the investor (i.e. the life company). In addition, where a tax charge is also levied by virtue of the s212 deemed disposal rules then the life company incurs a double (or triple) charge with no opportunity for offset.
- Where unit trust holdings or holdings in OEICS are sold to a manager in the same group, as the manager is a connected party, any capital loss arising on the sale can only be offset against a capital gain arising from a disposal to the same group company. The disadvantage is made worse if the group sells the manager to a third party and has stranded connected party capital losses, as there will then be no possibility of a future offset. Given that the manager is a market maker and the life company transaction is at market value for tax purposes, the application of the connected party rules is wholly unfair.

- 4.2 In terms of the CFC / offshore fund point above, the HMRC members present noted that they do not have responsibility for these areas of legislation. Therefore they would need to refer the industry's concerns to the relevant personnel within HMRC for them to consider further. HMRC asked whether in practice the double charge is, in fact, incurred by the company. The industry

representatives replied that, usually, on inspection of the tax return, the HMRC Inspector will see the double charge and, in practice, allow a non-statutory adjustment to offset the charges in the computation. However, under CTSA companies are required to submit their computations on the basis of incurring the double (or triple) tax charge. These provisions, therefore, create the uncertainty of a potential additional tax charge (which may be mitigated on an extra-statutory basis), and also create an additional compliance burden for all concerned.

- 4.3 In terms of the group manager issue, HMRC queried whether the industry representatives had attempted to estimate the quantum of stranded capital losses. The representatives confirmed that they had not. They made the point that, unless any changes to the legislation were retrospective, then previous trends may be irrelevant as it is impossible to predict the performance of these assets in the future. HMRC also noted that any prospective changes to the legislation may not be of immediate benefit to the industry, as the “connected party” may not be connected any more so the existing connected party capital losses will be stranded. The industry representatives stated that it would be inequitable for losses to become stranded in this way and suggested that if a connected party ceases to be connected as a result of a change in the legislation, any historic connected party losses should be available to be offset against gains on transactions with the same manager. However they noted that, going forwards, if the interaction of the connected party rules with s212 TCGA 1992 was changed, then it would eliminate the anomaly in the legislation for companies in future periods. HMRC agreed to consider this point further.
- 4.4 The industry representatives suggested that one possible remedy to the s212/CFC.offshore funds issue would be to change the legislation so that s212 TCGA 1992 overrides all the other provisions connected to the points raised above. HMRC agreed that this option is a possibility. The benefits of this would be:
- administrative simplicity
  - a more logical rule
  - an easy solution to implement

## **5 UTILISATION OF LOSSES (ISSUES 11- 16)**

- 5.1 HMRC noted that the issue surrounding the measurement of a life company loss (i.e. on an accounts basis or FSA return basis) would be considered further at a later stage. HMRC was content for losses computed on an FSA return basis to be surrendered to other life companies computing profits on the same basis, However where life company losses were to be surrendered to companies computing profits on an accounts basis, HMRC believed that there was a case for computing losses for surrender on an accounts basis as this would bring them into line with other industries. They questioned whether

the industry would consider this in respect of a “balanced package” to be agreed between HMRC and ABI. The industry’s view was that this point is not a subject for discussion. It believes that it is wrong in principle to calculate a loss on an accounts basis and profits on an FSA return basis. HMRC noted this and agreed to consider this matter further. (in addition to the fundamental objection in principle, the industry noted that in any case identification of a LTIF-specific loss would be problematic for companies reporting under IFRS.)

5.2 HMRC advised that they had noted the ABI’s requests in connection with the following:

- Can carry back for GRB losses against GRB profits of the immediately preceding year be provided?
- Can carry back for BLAGAB excess E against BLAGAB excess I of the immediately preceding year be provided?
- Can relief of GRB losses against GRB profits elsewhere within the group in the same year be provided?
- Can relief of BLAGAB excess E against BLAGAB excess I elsewhere within the group in the same year be provided?

HMRC will consider these issues further, and look at approximating their potential Exchequer costs. At present there could be no guarantee that HMRC will agree to these requests, However these may be items which might be negotiated as part of an agreed “package”, particularly if changes subsequently agreed elsewhere in the consultation process would have an Exchequer yield.

5.3 In terms of the restriction of PB losses (issue 15), HMRC noted that this issue is included in the Amalgamation of Businesses workstream and that both HMRC and the ABI are performing their own costing analysis in relation to the potential risk to the Exchequer. The Group agreed that this issue would be explored fully in the Amalgamation of Businesses workstream.

## **6 OPERATION OF S83(3) (ISSUES 3 – 10)**

6.1 HMRC questioned whether the introduction of a TAAR outlined in the TCondoc (and discussed in the Transfers of Business workstream) would improve the operation of s83(3). The industry representatives responded that this would only be the case if reinsurance were included within any new TAAR legislation. They reiterated that their concern with the operation of s83(3) is that “innocent” transactions are caught within the legislation. Often, s83(3) is not applicable as companies work around the provision i.e. by abandoning transactions which may lead to s83(3) being in point or by restructuring the transaction in an attempt to reduce the risk that s83(3) will apply. They advised HMRC that it would be useful if HMRC could provide examples as to the types of transactions which are of concern to them (without providing any confidential information). HMRC replied that it is variations on a number of different mechanisms by which transactions, particularly related to purchase of all or part of a business, are carried out which result in the company claiming relief

for a tax loss for what is essentially a capital matter. HMRC noted that special bonuses would be just one example of this. HMRC considered that tax risk was greater where there is an asymmetrical taxation treatment in the transferor / transferee.

- 6.2 The ABI confirmed that it is the wording of the s83(3) which can prove problematic for companies. In particular the potential application of “in connection with” in s83(3) is unclear and creates uncertainty for life companies. It was noted that if a loss genuinely arises after a transfer of business (e.g. due to different valuation bases in the transferor and transferee) then this loss should be allowable. HMRC suggested that the cause of such a loss may be genuine in third party Part VII transfers however they would not expect such losses to arise on intra – group transfers. The industry representatives responded that even for intra – group transfers, the valuation basis may be different in the two companies, for example if the companies are significantly different in size or have differing asset allocations. These causes may result in a genuine loss arising on a transfer of business.
- 6.3 The ABI also raised the point that currently there is no time limit to the application of s83(3) after a transfer of business. Commercially, it is very unlikely that a loss incurred a number of years after a transfer of business would relate to the transfer, although HMRC can argue this under the existing legislation. For example, s83(3) issues may arise where Court-approved schemes require shareholders to provide support for with profit funds in certain circumstances, for example, a deterioration of the solvency position, possibly years after the effective date of the scheme. The fact that a support mechanism is set out in the scheme means that s83(3) is potentially in point. HMRC agreed with this view, but advised that their difficulty is in establishing which losses are genuine and which are created “artificially”. The Group suggested some potential changes to the wording of the current legislation to replace the “in connection with” wording. These included examples such as “wholly and exclusively”, “expenses explicitly connected with the transfer” and “items arising outside the normal course of business”. HMRC agreed to consider this further.
- 6.4 The ABI reiterated that their concern does not just relate to s83(3) and transfers of business but also reinsurance as well. On occasion reinsurance is used as an alternative to providing cash consideration for a transfer of business (which would result in the company failing to meet the requirement in s139 TCGA 1992 for no other consideration). Therefore, any amendments to s139 TCGA 1992 arising from the consultation process may alleviate HMRC’s concerns.
- 6.5 The ABI suggested to HMRC that s83(3) has, in part, been superseded by s444AC ICTA 88, as the latter section will eliminate a loss on a transfer of business where the transferee company has received more liabilities than assets during the transfer.

- 6.6 The ABI also advised that s83AA FA 1989 lacks clarity as it does not prescribe how the amounts should be included in the tax computation. In addition, it does not fully prescribe how the provision should be applied for companies with categories of business taxable on a Case VI basis.
- 6.7 The ABI also noted that HMRC appear to have a continuing belief that life companies have the ability (and intent) to create artificial losses which are surrendered to group companies, and remain sceptical that losses arise as a result of genuine trading activity. In view of this, the Group agreed that it would be helpful for industry to arrange a seminar for HMRC in an attempt to improve their understanding of this area. HMRC agreed this would be helpful. HMRC was not suggesting that losses couldn't arise in life insurance companies for commercial reasons, but by the same token it was possible to create tax losses where there was no commercial loss. As noted in LAM 6.57, HMRC's view was that the Case I result should not be affected by fund additions.

## **7 STRUCTURAL ASSETS (ISSUES 20 – 21)**

- 7.1 The Chairman read out some analysis to the Group which was drafted for an earlier version of the TCondoc but omitted from the final version. The document was not available for circulation to the Group. HMRC set out their views on structural assets as follows:

The Chairman noted that it was long established in case law that where any financial trader held assets for the purposes of the trade, income arising from such assets was a trading receipt and profits or losses arising from such assets were profits or losses of the trade.

For most financial traders, it is a question of fact whether assets are held for the purpose of the trade. However, for life insurance companies, following the establishment of the "long term business fund (LTBF)" in 1973, the initial assumption is that assets within the LTBF, or long term insurance fund (LTIF) as it is currently known, are assets on which an investment return arises which would be a trading receipt and an investment return on assets held outside the LTBF/LTIF would not be a trading receipt.

The Chairman appreciated that not all assets of a company's LTIF are assets primarily held to produce a return. For example, a mutual life insurer will hold assets such as real property or fixtures & fittings for its own offices where it conducts business, or shares in subsidiary companies, within its LTIF because it has no alternative. Such assets are commonly referred to as 'structural' assets. Also, while the regulator has encouraged proprietary life insurance companies to divest themselves of such structural assets, some, for historical reasons, still hold 'structural' assets within their LTIF.

The structural nature of certain assets is recognised for tax purposes in some circumstances, for example the substantial shareholdings exemption. The substantial shareholdings exemption applies to life insurance companies, but

the minimum holding qualifying for exemption is set at 30%, which is higher than the 10% qualifying level for other types of company. The insurance industry has asked for the qualifying level for life insurers to be reduced to 10%, to give parity with other companies. However HMRC's reasons for the higher level set for life insurers are set out in LAM 4A.263, and this is not something which HMRC was seeking to change as part of the current exercise.

As far as dividends from subsidiaries are concerned, the insurance industry has argued that it is unfair to tax life insurers on dividends from 'structural' subsidiaries, as other financial traders would not be taxed on such dividends.

The Chairman noted that other financial traders are liable to tax on dividends arising from shares held as part of the trading book, and for a life insurance company, the presumption is that assets of the LTIF are in essence trading assets.

The Chairman also noted that in the run up to the introduction of the substantial shareholdings exemption, the insurance industry was offered, but did not take advantage of, a period of grace when S440 would not apply, to allow transfer of subsidiaries or other substantial shareholdings out of the long term fund. Most industry representatives were unaware of this offer, and those who could remember it thought that it came with unacceptable conditions attached.

Meanwhile, as part of the current TCondoc process, HMRC was willing to consider any further representations the insurance industry wished to make on structural assets. If the industry wished to make such representations, the Chairman asked if, in the first instance, the industry's views on how those assets for which non-trading treatment was seen as appropriate should be identified, what should be the treatment of increases in the value of such assets, and whether (and if so why) any distinction should be drawn between assets held in a with-profits fund and those held in a non-profits fund.

- 7.2 HMRC questioned whether it would be beneficial for the industry to produce a paper which outlined their view on structural assets. The industry representatives questioned how useful this would be if HMRC are not considering changing any of the legislation in this area. HMRC replied that it possible that an amnesty similar to the one offered prior to the introduction of the SSE legislation may be offered again in the future. Both HMRC and the ABI agreed to refer back to the papers prepared / received at the time of the previous amnesty to see the nature of the offer and the conditions attached. The ABI agreed to consider the possibility of a restructuring "amnesty" as outlined by HMRC.
- 7.3 HMRC confirmed that they do not believe it is likely that the SSE rules applicable to life companies will be changed to reduce the percentage holding required from 30% to 10% in line with other industries. The industry representatives noted that they are aware of some groups with subsidiaries such that a reduction from 30% to 10% holding would impact their ability to be exempted by SSE, for example, investments in distribution channels post-

depolarisation are increasingly being structured with a number of insurers taking, for example, 20% stakes. HMRC agreed to give this matter further consideration.

- 7.4 The ABI reiterated that, in their view, as they stand currently the rules in relation to the taxing of dividends received from subsidiaries of the long term fund are not consistent with those for other industries and they would like parity with those industries. Currently some life companies have subsidiaries with distributable reserves which they cannot release upstream due to the fact that a tax charge would be incurred. HMRC noted this and requested that the ABI perform some analysis outlining the cost of allowing relief for the shareholders' share of such dividends.

## **8 NEXT STEPS**

- 8.1 The Group agreed that the key issue for consideration is s83(3). Both HMRC and ABI are requested to provide examples of circumstances where s83(3) would apply (HMRC) or has been applied (ABI). The ABI also requested HMRC to provide a statement of principles to outline the types of transaction which s83(3) is designed to discourage.
- 8.2 The Group agreed that currently HMRC and the industry have very different views as to whether it is appropriate to measure a loss for surrender by a life company on an accounts basis instead of on an FSA return basis. This issue will be considered further at a later date.
- 8.3 The ABI agreed to provide examples of cases where the application of s212 TCGA 1992 creates difficulties for companies in respect of transfers of business, connected party trapped losses, CFC / offshore fund legislation (issues 17 – 19).
- 8.4 HMRC will update and circulate the issues list for this workstream.
- 8.5 The next meeting with HMRC is due to take place towards the end of August. The ABI will prepare draft minutes of this meeting for circulation to both ABI members and HMRC.