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Dear [Industry person]

Pre Budget Report ('PBR') 2006

1. This is the PBR 2006 letter for the insurance sector. Following the approach adopted for Budget 2006 it again covers both indirect and direct tax issues, and includes a section on work being led by HM Treasury. Appropriate points of contact are identified for the different strands of activity.
2. The aim of this letter is to highlight those measures and announcements of particular interest to the insurance sector, and, if possible, to provide a bit more detail than found in the formal material found in HMRC Press Releases and Pre Budget Report Notes. In addition, this letter gives a progress report on the Life consultation, and gives some details on other issues of interest to the sector where work is ongoing. This may be helpful where, for example, your clients or members will have to change their systems or take other urgent steps towards the implementation of some of the measures.
3. This year has been an extraordinarily busy one for all of us concerned with the taxation of the insurance industry. PBR 06 contains a number of measures which have been the subject of detailed consultation in one form or another. In addition, wider initiatives, such as the Varney review of *Links with Large Business* and the *City Strategy*, have involved significant external input from members and representatives of the insurance industry. HMT and HMRC are very grateful for the contributions that have been made, and that continue to be made, on a number of fronts.
4. You will be interested to know that we now have a special 'Life Assurance' section on the HMRC website. This will be used to provide news and links to items of interest, such as material from the various life consultation working groups, draft legislation etc.. The link to these pages is:

Information is available in large print, audio tape and Braille formats.
Type Talk service prefix number – 18001

Geoff Lloyd (Director)

<http://www.hmrc.gov.uk/life-assurance/index.htm>

5. In the summer I asked you all to identify 'gaps in HMRC knowledge', with a view to addressing these gaps through a series of seminars. This initiative has had to take a slower track than originally envisaged, because we have all been busy with other things. But I will be circulating the list of items you identified shortly, with a view to staging the seminars in the spring.
6. Finally, you will be interested to know that HMRC, HMT and the ABI will be shortly carrying out a stock-take exercise, to identify the learning points from the way we have all worked together over the past year. The publication of the *Varney/Links with Business* review gives the exercise greater significance because it would be helpful to others if we could spend a little time capturing the 'working together' issues we had to address 12 months ago and how we have gone about it. For the avoidance of doubt, I recognise that there is still a lot of work to do, on a wide range of issues, so there is no room for complacency. But in terms of what we have achieved to date – by which I mean all those involved, the insurance industry, HMRC and HMT – we clearly have a good story to tell. I would welcome contributions to this exercise, either directly or through the ABI.

Yours sincerely

Jeremy Tyler

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Business wide initiatives and policy development

Varney review: Links with Large Business

1. The Government has committed to implementing in full the recommendations of the *2006 Review of Links with Large Business*, published by HM Revenue & Customs (HMRC) on 17 November 2006. The review, led by Sir David Varney, conducted extensive, open consultation to identify opportunities to further improve the extent to which the views and experiences of large business are taken into account in the administration of the tax system.
2. It proposes a series of commitments for HMRC, to be introduced over a timeframe up to Spring 2008, designed to provide business with:
 - greater certainty about the tax treatment of their commercial activities, including the introduction of an advance rulings process for significant investment;
 - a more efficient risk based audit approach;
 - quicker resolution of enquiries;
 - and greater consultation with business over future changes to the tax administration.

A Large Business Advisory Board, including senior business representatives, will be established to oversee implementation of the proposals.

Contact point for further details: John Roche on 020 7438 4428 or john.roche@hmrc.gsi.gov.uk

City Strategy

3. The Chancellor of the Exchequer, Gordon Brown, and the Economic Secretary, Ed Balls, met with members of the High-Level City Group, including senior representatives from across the financial sector, on 18 October, to discuss proposals to maintain and enhance the City of London's competitiveness throughout the world. The intention is to develop an open and constructive dialogue on how best to ensure the continued global success and competitiveness of London's financial markets and the UK based financial sector.
4. The group discussed a number of proposals, in relation to which work is being taken forward, including maintaining cutting edge principles based regulation for financial services and promoting, in a new joined up strategy, the UK based financial sector in overseas markets. In addition, there was discussion on modernisation of the wholesale insurance market. Working with key players in the sector, Lord Levene will develop a plan to deliver further market reforms to improve efficiency, building on the recent introduction of some electronic trading, and, in parallel, the Government will examine the business environment for the wholesale insurance sector.

Contact point for further details: David Edney on 020 7270 6103 or David.Edney@hm-treasury.x.gsi.gov.uk

Treasury Sector project

5. HMT has undertaken a strategic insurance sector project, covering general and life insurance as well as Lloyd's. The aims of the project include improving understanding of the structure, economics and business drivers of the sector to better determine the impact of new and existing policy measures, and to better understand key trends and current and

medium term challenges facing the sector. HMT is very grateful to all those who have contributed to the project, findings from which are improving understanding of the pressures on the sector and helping to shape work being done in relation to the sector.

Contact point for further details: Lisa Cristie on 020 7270 6495 or lisa.cristie@hm-treasury.x.gsi.gov.uk

Indirect Tax

Andersen update

6. In the 2005 Pre-Budget Report, the Government announced it would delay implementation of the March 2005 ECJ judgment in the case of Arthur Andersen & Co Accountants concerning VAT and insurance-related services pending progress in the European Commission review of the VAT treatment of financial services and insurance. The Government will continue to monitor the progress of the review in deciding whether to make the necessary changes to UK law, and will provide industry with sufficient notice following any decision to implement.

Contact point for further details: Barbara Farndell on 020 7147 0245 or Barbara.Farndell@hmrc.gsi.gov.uk

VAT partial exemption special method declaration

7. Following the recent consultation on partial exemption special methods, two changes will be implemented with effect from 1 April 2007.
8. The first change (the Method Declaration) will require a business to declare 'to the best of its knowledge and belief' that its proposed special method is fair and reasonable. The declaration will enable HMRC to give much faster approval helping lower compliance costs for businesses and enabling HMRC to focus on other issues. HMRC will be able to set aside a method which the person signing the declaration knew or ought reasonably to have known was not fair and reasonable. This would require the business to recalculate past returns to ensure that it only recovered a fair and reasonable amount of VAT.
9. The second change (the Combined Method) is a simplification designed to help businesses that make certain overseas supplies that confer the right of VAT recovery (for example, supplies of insurance and insurance related activities to customers outside the EU). The law currently requires this VAT to be calculated separately from a method, which many businesses find cumbersome. The Combined Method gives these businesses the legal right to a special method that caters for VAT recoverable on overseas supplies.
10. There was widespread support for the Combined Method and a number of suggested improvements have been made to the Method Declaration as a result of the consultation. A more detailed analysis can be found in the Regulatory Impact Assessment which, together with guidance and legislation, will be published in January 2007.

Contact point for further enquiries: Patrick Wilson on 0207 147 0595 or e-mail patrick.wilson@hmrc.gsi.gov.uk

IPT issues

11. No changes have been announced to insurance premium tax in the PBR.

Direct Tax

Life Consultation: progress update

12. For the past 6 months five working groups comprising HMRC specialists, representatives from industry, accountants and lawyers have been hard at work addressing the issues set out in the Technical Condoc published in May 2006. These discussions have been marked by a willingness on all sides to be co-operative and to work in an atmosphere of mutual trust. We are very grateful for the considerable effort that has been made by the industry over the past six months on this front.
13. The PBR includes the first outcomes of this work, as described below. The working groups will continue to have a role reviewing draft legislation etc., to ensure that it is fit for purpose. The working groups will also continue to consider the issues falling within their remit until all outstanding issues have all been covered.

Contact point for further details on the consultation generally, or other industry liaison issues: Jeremy Tyler on 020 7147 3362 or jeremy.tyler@HMRC.gsi.gov.uk

Transfers of business

14. Work in the transfers of business strand quickly polarised around two key issues: the clearance procedures and the need for revenue protection proportionate to the tax risks that HMRC encounter from time to time in business transfers.
15. On the first of these issues there was consensus that the processes governing HMRC clearance and comforts for transfers are over-elaborate, partly driven by the requirements of the FSA and the independent actuaries who have to report on the transfer. The PBR includes proposals, including draft clauses, to drastically simplify the legislation in this area and to put into statutory form certain 'comforts' which are often sought in the course of clearances. We are also proposing to simplify our practice in dealing with insurance business transfers and to improve guidance to prevent unnecessary enquiries. This will be a significant deregulation and will reduce the administrative burdens on companies and their advisers as well as HMRC in transfer cases.
16. On the second issue a consensus was harder to come by. But there was recognition that, in recent years, a substantial amount of very complex and widely drawn anti-avoidance legislation had been added to the statute book. The PBR includes proposals, with draft clauses and Explanatory notes, to sweep away much of the existing legislation and replace it with:
 - a simple rule applying to a transferor (ensuring that assets that do not go to the transferee's LTIF are brought into account at fair value – see new section 444AB ICTA)
 - two rules applying to the transferee: one, new section 444AC ICTA replaces the old section 444AC(2) rule excluding acquired surplus but is better targeted; the other, new section 444ACZA ICTA, deals with an excess of liabilities over assets
 - a targeted anti-avoidance rule ("TAAR") (section 444AEA ICTA) dealing only with Case I and applying separately to the transferor and transferee (but with the possibility of the rule not applying if overall there is no tax advantage).

17. The anti-avoidance rule will have its own clearance procedure, and will be the only formal clearance procedure applying to transfers of business, as section 444A(8) ICTA and section 211(2) TCGA are repealed and replaced respectively.
18. Because a clearance procedure cannot be effectively instigated until the legislation enacting it is on the statute book it is proposed that the principal simplifications, including the anti avoidance rule and the clearance procedure, will only have effect in relation to business transfers taking place on or after 1 November 2007. This will give industry the lead time it has asked for to digest the effects of the new proposals in relation to transfers that are already underway. But the new section 444AB which merely codifies existing provisions affecting a transfer will have effect from 1 January 2007.

Contact point for further details on transfers of business: Richard Thomas on 020 7147 2558 or richard.thomas@HMRC.gsi.gov.uk

Amalgamation of business categories

19. Amalgamation of the non BLAGAB business categories was first mooted in 2003/4. That was in the consultation on potential wider reform of the Schedular system for corporation tax (which did not go ahead), which included a proposal to effect a major simplification and reduce administrative burdens on companies by amalgamating five of the categories into one and a further simplification by also amalgamating a sixth (Permanent Health Insurance or PHI), which is calculated on a rather different basis.
20. This years Technical Condoc set out the pros and cons as the Government saw them of both amalgamating 5 into 1 and 6 into 1 but it indicated that the Government's preference was for 6 into 1. Draft clauses were also published illustrating how both these amalgamations could be legislated.
21. In the working group the industry argued that 5 into 1 is appropriate and welcome but has opposed the amalgamation of the sixth category. In putting forward reasons why, the industry has in fact demonstrated that there would be a fairly substantial cost to the Exchequer in amalgamating the sixth category. And there are other reasons for the separation of PHI from other categories acknowledged by the Government in the Technical Condoc.
22. The working group also considered the need to ring fence any pension business losses that will exist at the end of 2006. After considering the available evidence the working group agreed that the cost of not ring fencing losses was significant at this time.
23. The PBR includes proposals, with draft clauses and Explanatory notes, to amalgamate the five categories other than PHI for periods beginning on or after 1 January 2007 and that pension business losses at the end of 2006 will be ring-fenced.
24. It is hoped that a "Keeling" Schedule of life assurance tax legislation as it would look amended for both the transfers of business and amalgamation drafts will be put on the new Life Assurance part of the HMRC website shortly.

Contact point for further details on amalgamations: Craig Norris on 020 7438 6731 or craig.norris@HMRC.gsi.gov.uk

Crown option

25. At the outset of consultation both sides recognised the benefits of doing something about the Crown Option. Events in 2006 have underlined the difficulties that the industry faces given uncertainty about when a discretionary rule such as the Crown Option might be applied. One such event is the FSA's recent announcement that they are proposing to relax their very strict rules on calculation of reserves for some life assurance business (CP6/16). The relaxation means that companies will have the opportunity to reduce reserves in 2006, potentially by £billions, with a commensurate increase in profits. Were the Crown Option to be exercised in any such case there could be a significant increase in the tax due from the company.
26. The apportionment working group has therefore been considering options for replacing the current, discretionary Crown Option with a clear and automatic legislative solution. This work continues and although draft clauses will not be available for PBR work is proceeding towards a resolution of industry concerns in this area. Draft clauses will be published as soon as they are available with a view to consultation leading up to the Finance Bill.

Contact point for further details on the Crown option: Jeremy Tyler on 020 7147 3362 or jeremy.tyler@HMRC.gsi.gov.uk

Friendly Societies

27. The Friendly Society working group has identified four issues to consider. Of these one - the ability of a friendly society to transfer tax exempt life or endowment business to an insurance company and retain the exemption – has progressed to the point where proposals can be made.
28. This issue had been raised before the current consultation without a convincing case for change emerging. The working group discussions have helped to clarify the issues involved. For example, where a friendly society converts itself into a company, the exemption may be carried over. However there is a much higher cost for a friendly society to convert to a company rather than to transfer its business to another company. In addition the friendly society representatives accepted a slightly narrower proposition than hitherto sought, namely an exemption only for business which was on the stocks at the time of transfer; and that there should be safeguards to prevent the exploitation of the continuing exemption.
29. The PBR includes proposals, with draft clauses and Explanatory notes, to allow a friendly society to transfer tax exempt life or endowment business to an insurance company and retain the exemption. The proposals will have effect for transfers taking place on or after 1 November 2007.
30. In terms of safeguards any such transfer of business will be made subject to the anti-avoidance rule for business transfers described above. This would ensure that a friendly society could not be used as a feeder for new business transferred to a life insurance company. In addition, the legislation will make clear that at the point of transfer the existing tax exempt business is frozen and that the life company cannot increase the premiums to increase the exempt amount.
31. The 3 issues still under discussion are:
 - the ability of a friendly society to transfer tax exempt other business to another society or to a company and retain the exemption.
 - A simplification of the rules applying to the smallest societies where the rules have the most disproportionate effect.

- Changes in the rules regarding inadvertent breach of exempt premium limits through holding multiple tax exempt policies following a divorce settlement, or similar circumstances outwith the policyholder's direct control.

Contact point for further details Friendly Societies: Jim Craig on 0131 777 4156 (Edinburgh) or james.craig@HMRC.gsi.gov.uk

Group issues and losses

32. This strand has considered a piece of much disliked legislation (section 83(3) Finance Act 1989) which limits a company's losses where there is an addition of funds in connection with a transfer of business. This is viewed by industry as inhibiting commercially-driven consolidation.
33. The proposed anti-avoidance rule for transfers of business, together with related changes from the transfers of business work strand, mean that this legislation will no longer be needed. The PBR therefore includes proposals to repeal the legislation, with effect from 1 November 2007. The repeal and consequential changes are included in the draft clauses for transfers of business.
34. Discussions continue on another significant issue, the treatment of structural assets and on other miscellaneous changes.

Contact point for further details group issues and losses: Colin McHardy on 020 7147 2614 (London) or 01382 424333 (Dundee) or colin.mchardy@HMRC.gsi.gov.uk

Apportionment

35. This strand is key to solving a number of difficulties in the life assurance tax field. But because it is such a difficult area the working group is continuing to consider the issues over a longer time frame, without risking the inclusion of unsatisfactory legislation in the 2007 Finance Bill.

Contact point for further details on apportionment: Jeremy Tyler on 020 7147 3362 or jeremy.tyler@HMRC.gsi.gov.uk

Other issues

Reserve releases following FSA Condoc CP6/16 (and CP6/12)

36. A working group has been set up along the lines of those used in the ongoing life consultation, to consider the potential tax impacts of the proposed changes to the FSA reserving rules. The working group is examining ways in which the tax impact of the reserving rule changes might be mitigated, for example through some form of spreading.
37. Although it will be impossible to complete this work in time for comprehensive regulations to be in place before the end of 2006, an interim solution is being considered. This should provide the necessary degree of certainty that insurers need for 2006, allowing the working group to complete its work early in 2007.

Contact point for further details on reserve releases: Stephen Bibby on 020 7438 9127 or stephen.bibby@HMRC.gsi.gov.uk

Inadmissible assets and FSA valuation rules

38. Case teams in the Large Business Service have recently seen a number of cases where insurance groups have used the FSA valuation rules to generate a permanent loss of tax to the Exchequer simply by restructuring the group.
39. Although the particular arrangements vary the tax effect sought turns on the interpretation of section 83(2B) Finance Act 1989, and in particular, an interpretation which means that an initial tax loss arising from the difference between fair value and admissible value of an asset in a long term insurance fund is not subsequently reversed when, for example, the asset is distributed to shareholders. If that view is correct, then the difference between fair value and admissible value, which has in the cases seen by HMRC been several hundred million pounds, will permanently escape taxation.
40. On the basis of an opinion by leading Counsel, HMRC does not accept that section 83(2B) does not apply in the relevant circumstances. However given the significant amounts at stake and the potential for wider exploitation across the sector, the PBR includes proposals to clarify section 83(2B) with effect from 6 December 2006¹. Draft legislation to do this is included in the transfers of business Schedule at paragraph 11(2) and see also paragraphs 84 to 86 of the Explanatory Notes. This will ensure that any difference between fair and admissible value is brought into tax when an asset leaves the long term insurance fund.
41. It should be noted that HMRC consulted with the ABI on a confidential basis prior to taken the step of announcing the proposed change to section 83(2B) without fuller consultation. These discussions concerned the commercial rationale for the type of arrangements encountered, with a view to ensuring that they were appropriately and accurately targeted by the PBR proposals. Fuller consultation can now take place.
42. The PBR note on this issue mentions that there are two other circumstances when a value is put on assets that is less than their fair value. It is now proposed to extend the scope of the current Technical Consultation on life insurance tax rules to consider the extent to which the tax rules should recognise the valuation rules where they give a value lower than fair value. We will discuss with the ABI how best to do this.

*Contact point for further details on inadmissible assets: Richard Thomas on 020 7147 2558 or
richard.thomas@HMRC.gsi.gov.uk*

General Insurance

General Insurance Reserves (section 107 FA 2000)

43. We are extremely grateful for the contributions to the informal consultation process. These discussions have enabled the joint HMRC / industry Working Group to identify a way forward that is the best fit with both HMRC and industry imperatives. The PBR includes proposals, with a draft regulatory impact assessment, to repeal section 107 FA 2000, with further consultation to resolve outstanding issues.

¹ Corrected from '2007' as incorrectly shown in version issued 6.12.06

44. The outstanding issues are the nature of any transitional arrangements and the development of a narrowly targeted revenue protection measure to protect against tax loss through tax driven over reserving. The approach under discussion is to 'cap' reserves for tax purposes to a level based on a modern assessment of a reasonable prudential margin. The line beyond which a general insurer's reserves might be regarded as excessive is something to be discussed by the Working Group in framing a revenue protection measure.
45. Repeal of section 107 and introduction of the new measure will take effect for accounting periods ending on / after the date that Royal Assent is given to the Finance Bill.

*Contact point for further details on general insurers reserves: Simon Claydon on 020 7147 2545 or
simon.claydon@HMRC.gsi.gov.uk*

Modernisation of Lloyd's tax rules

46. Finance Bill 2007 will address the peculiarity related to Lloyd's special accounting rules that prevents the transfer of trading losses in a company reorganisation from one corporate member to another under the same control. The intention is that the rules at section 343 ICTA 1988 will work for Lloyd's corporate members in the same way as they work for other companies. Draft clauses will be made available to for discussion with Lloyd's and Lloyd's members.
47. The change will take effect for accounting periods ending on / after the date that Royal Assent is given to the Finance Bill.
48. Although not announced at PBR, we have been discussing with Lloyd's regulations to create a pool of foreign tax suffered by corporate members from various sources and available for relief against UK tax. The amount of foreign tax entering the pool will be restricted where the foreign rate of tax is greater than the UK rate. This will be done by applying a fraction reflecting the difference in rates. These regulations ("Lloyd's Underwriters (Double Taxation Relief) (Corporate Members) Regulations") will have effect for periods of account ending on or after the date of coming into force. In practice this means that they will apply to periods of account ending on or after 31 December 2006.
49. We are grateful to Lloyd's for their assistance with these regulations and will continue to discuss changes to the tax rules affecting Lloyd's members with Lloyd's.

*Contact point for further details on Lloyd's issues: Victor Baker on 020 7147 2616 or
victor.j.baker@HMRC.gsi.gov.uk*

Pensions

Pension term assurance

50. As part of its PBR announcement, the Government has re-stated its policy that the purpose of pensions tax relief is to provide an income in retirement. It is not the purpose of the relief to enable stand alone life insurance to attract tax relief.

51. HMRC want to work with the industry between now and the Budget to discuss the best way to restrict tax relief for arrangements, which are entered into on or after today, providing lump sum benefits where these are disconnected from wider retirement saving.
52. The review of tax relief for lump sum benefits under the pension rules is to be led by Martyn Rounding and Stephen Webb of HMRC. They will be inviting you to attend a preliminary meeting to discuss the PBR announcements to be held before Christmas.
53. HMRC would emphasise that the Government's main concern is about personal life insurance policies being re-badged for sale as personal pension arrangements and it is not the Government's intention that any action it may announce in the Budget will affect existing types of occupational scheme, including where the occupational scheme only provides death in service benefits.
54. For further details you can contact *Stephen Webb on 020 7147 2872 or Stephen.t.webb@hmrc.gsi.gov.uk or Martyn Rounding on 020 7147 2821 or Martyn.Rounding@hmrc.gsi.gov.uk*

Alternatively secured pensions

55. You may also be interested in the changes that have been announced today, which will tighten up the provisions on alternatively secured pensions. Measures will also be introduced to prevent other benefit options, such as scheme pensions, being used as a means to pass on tax-favoured funds. HMRC want to discuss with you some specific aspects of these changes and, in particular, what alternative treatment is needed for members that the scheme has been unable to trace by their 75th birthday, who we understand are currently defaulted into alternatively secured pensions.
56. Further details can be found in the relevant PBR note, or contact *Angela Walker on 020 7147 2820 or angela.walker@hmrc.gsi.gov.uk*

Miscellaneous Pensions PBR package

57. There is also a package of measure to ensure that the pension tax rules continue to meet the original intentions and reduce costs in administering the pension tax rules where possible. Draft legislation will be published in the New Year making technical improvements to:
 - Investment-regulated pensions schemes and UK-Real investment trusts
 - Transfers and transitional protection
 - Ill health retirement
 - Pension commencement lump sum rules
 - Unsecured pension fund rules
 - Two year time limit on lumps sum death benefits
 - Winding up lump sums – conditions to be satisfied.
58. HMRC will begin discussions about Trivial Commutation and will consult about improvements to one of the lifetime allowance tests (BCE3) and Dependents' Scheme Pensions. A PBR Notice, a consultation document and partial regulatory impact assessment, all published today, contain further details.
59. Further details can be found in the relevant PBR note, or contact *Anne Stubbs on 020 7147 2844 or Anne.Stubbs@hmrc.gsi.gov.uk*

Other issues of potential interest to insurers

(More detail about these measures, and appropriate contact points, can be found in the relevant PBR note.)

UK REITs

60. Legislation to introduce UK-REITs was included in FA 2006. There are some loose ends that were not tied up in time for FA 2006. Unforeseen interactions and other consequences have also come to light as implementation approaches. Finance Bill 2007 will include minor repairs, to make the regime work as was always intended.

Stamp Duty Land tax changes

61. Regulations have been made today to make ineffective a number of schemes designed to avoid stamp duty land tax. The regulations will only have effect for 18 months as the intention is that they should be replaced by primary legislation, in Finance Bill 2007. Representations are invited on the regulations so as to inform the scope and drafting of the primary legislation.

Individual Savings Account ('ISA') Review

62. On 1 November Ed Balls, Economic Secretary to the Treasury announced that ISAs will be made a permanent feature of the savings landscape, the Government's primary savings vehicle outside pensions. Other changes were also announced, the intention being to simplify the ISA regime and increase its flexibility for providers and savers. The PBR includes a consultation document on implementing these changes

Carter 2: HMRC online services

63. The Government accepted Lord Carter's recommendations about increasing use of HMRC online services, at Budget 2006. In July 2006, following responses to the partial RIA, Lord Carter revised his recommendation for income tax self assessment. From 2007-08, the filing dates will be 31 October for paper ITSA returns and 31 January for online returns. There are no changes planned to the third party time limits, for providing information to ITSA taxpayers.
64. HMRC and Companies House launched a joint consultation on aligning filing dates for companies in November 2005. The Government has now decided that alignment should remain voluntary for the time being. HMRC and Companies House will develop a joint filing service for companies. The law will also be changed to give earlier certainty to companies that file early. The statutory deadline for filing company tax returns will not be changed at this time, but will be kept under review.
65. It is recognised that in due course the handling of complex life tax computations will need to be considered.

Taxation of foreign profits: Controlled Foreign Companies

66. The Government is determined to maintain the overall competitiveness of the UK, and has held a productive dialogue with stakeholders on the taxation of foreign profits. The Government will consult with business in 2007 on a package of reform.
67. In the PBR, the Government has announced that following the recent European Court of Justice (ECJ) judgment in Cadbury Schweppes, changes to the Controlled Foreign Companies (CFC) rules are being made, with effect from 6 December 2006, to ensure the

rules remain effective and to provide increased certainty for business. Draft guidance and legislation is available on the HMRC web site at www.hmrc.gov.uk/pbr2006/.

68. The changes will relax UK CFC rules by enabling UK companies to apply to HMRC to disregard those profits of their CFCs that arise from genuine economic activity in business establishments in other European Union member states, or in certain other states in the European Economic Area (EEA). Also, a highly artificial avoidance scheme will be closed off by abolishing the public quotation exemption in the current rules.
69. For these purposes, the profits identified as arising from “genuine economic activities” are those created by the labour of the individuals working for the CFC in its EEA business establishment(s).
70. There could obviously be implications here for captive insurance companies. If the draft guidance and draft legislation on the HMRC web site doesn’t answer your questions about these changes, please contact the CFC Team in International CT (Team Leader: *Mary Sharp*, Telephone: 020 7147 2656 or email mary.sharp@hmrc.gsi.gov.uk).

Property in Authorised Investment Funds

71. Alongside the introduction of UK-REITs, the Government has been considering the taxation of Authorised Investment Funds that invest in property. The Government has been consulting with interested parties and has identified a number of significant challenges. The Government will continue dialogue with stakeholders to establish how best to address these challenges.

Holdings in Authorised Investment Funds & DTR

72. Regulations have been laid today which prevent a financial concern which treats dividend distributions from an authorised unit trust or an OEIC (“AIFs”) as part of its trading receipts from circumventing the restrictions on double taxation relief in section 798A ICTA and section 803C ICTA as that section applies to business other than life assurance business. This rule applies only where the financial trader and other group members together hold 50% or more of the rights in the AIF (but not counting holdings in the long-term insurance fund of any group member)
73. Life assurance business is excluded because holdings in AIFs are a normal incident of a life insurer’s activities. But the Government is concerned that such holdings are not used to get round the rules in section 804C ICTA as they apply to companies carrying on life assurance business. HMRC therefore proposes to discuss the issue with the industry with a view to making a recommendation to Ministers for Budget 2007.

Capital Gains tax avoidance

74. Draft legislation and guidance have been issued at PBR for a targeted anti-avoidance rule (‘TAAR’) for Capital Gains Tax, building on the first of the three TAARs introduced last year for companies. There is no change to the effect of the equivalent rule for companies, which is now in section 8(2A) to (2C) of the TCGA, but that rule is being extended to individuals, trustees and personal representatives. The rule provides that a capital loss is not an allowable loss if it arises as part of arrangements which have a tax advantage as their main purpose, or one of their main purposes. The intention of this provision is to deter the creation and use of artificial capital losses, for example via the use of second hand life insurance policies. However, it is not expected to have any effect on the commercial market for second hand life assurance policies.