

2006 Pre-Budget Report



**HM Revenue
& Customs**

PBRN 11

6 December 2006

LIFE INSURANCE COMPANIES: EXPLOITATION OF FSA VALUATION RULES

Who is likely to be affected?

1. Life insurance companies.

General description of the measure

2. This measure ensures that any difference between the fair value and the admissible value of an asset held in the long-term insurance fund (LTIF) of a life insurance company is brought into tax when the asset leaves the LTIF.

Operative date

3. This measure will have effect for transactions taking place on or after 6 December 2006.

Current law and proposed revisions

4. In arriving at the profits of life assurance business for tax purposes, the computation includes the income from, and the increase in value of, the company's assets that are held in its LTIF. This ensures that there is a proper match between the company's earnings on its investments and the increase in the amount it has eventually to pay its policyholders by way of benefits.
5. For ordinary accountancy purposes, the increase in the value of assets is computed by reference to their market or fair value. In most cases this is also done for life insurance companies. But because what is taken into account for tax purposes is the value of a life assurance company's assets as they appear in its regulatory return made to the Financial Services Authority (FSA) and not as they appear in its Companies Act accounts, there can be circumstances where the assets are valued at less, and in some cases very substantially less, than their fair value.

6. There are three main circumstances in which assets are valued at less than their fair value for the purposes of the FSA return. This measure applies to one of those circumstances, where one life assurance company holds the shares of another in its long-term insurance fund. Under FSA rules, the value, known as the admissible value, that can be put on any such shares is extremely limited.
7. HM Revenue & Customs (HMRC) has recently seen a number of cases where insurance groups have taken advantage of this FSA valuation rule to generate a permanent loss of tax to the Exchequer simply by restructuring the group. The particular arrangements vary, but the main features are these:
 - Life assurance company A acquires the shares of another life assurance company B, both of which are in the same group of companies.
 - The shares in B are acquired for their market value.
 - When A makes up its FSA return for the period in which the purchase takes place it must write down the value from fair value to admissible value, as required by FSA rules. It therefore recognises a loss in this period. In the cases HMRC has seen this loss will typically be several hundred million pounds.
 - Were A to sell the shares in B, it would be required to do so for their market value and the write down from fair value would be reversed. But this is not what is done in the cases seen. Instead the shares in B are transferred out of the long-term insurance fund and into another part of the company as a distribution of surplus *in specie* and the rules require that distribution be shown at admissible value, which can be very substantially less than fair value.
8. In carrying out the final leg of this transaction the company is assuming that section 83(2B) of the Finance Act 1989 will not apply to recapture the difference between fair value and admissible value when the distribution *in specie* is made. 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.
9. Another way of seeking to ensure that the loss created by the write down to admissible value is permanent, and that tax is never collected on the full value of the shares in B, is to transfer the business or part of the business of company A to company C (another group company) and to include in that transfer the shares in B. Again this presumes that section 83(2B) will not apply to recapture the difference between fair value and admissible value when the final transfer takes place.

10. On the basis of an opinion by leading Counsel, HMRC does not accept that section 83(2B) does not apply in the circumstances outlined above, and will contend in appropriate cases that section 83(2B) operates to recapture the difference between admissible and fair value for tax purposes. However given the significant amounts at stake and the potential for wider exploitation across the sector, section 83(2B) has been clarified with effect on and after 6 December 2006 to ensure that any difference between fair and admissible value is brought into tax when an asset leaves the long term insurance fund.
11. Draft legislation has today been published on the HMRC website.
12. Paragraph 6 above notes that there are three main circumstances where a value is put on assets, which is less than fair value. The above measure deals with one of these circumstances. The other two are:
- where the assets exceed a certain proportion of total assets (concentration risk) or there is over reliance on one counterparty (e.g. a bank)
 - where the nature of the assets is such that the FSA rules give them no value. Examples of such assets include intangible assets, gold, and some assets which are too contingent to be valued.
13. HMRC has seen instances where companies take advantage of these rules to reduce the value of their investments and to reduce the income they bring into account for tax purposes.
- One arrangement involves deliberately creating counterparty risk by putting all bank deposits into one bank for a short period covering the end of the year.
 - In another arrangement companies change the way they account for recovery of commissions when a policy lapses, moving from accounting for lapses as a reduction of reserves to treating lapses as assets which cannot be given a value.
14. The deferral of tax created by writing down asset values in this way is to some degree temporary, though the first arrangement mentioned in paragraph 13 above can be repeated year on year to give a permanent deferral. However, even temporary deferral for one year can result in losses being created, which can be surrendered as group relief in the year they are created, which would not be available if there were no deferral. This leads to an immediate loss of tax.

15. The Government considers that the effect of the valuation rules for life insurers can be to give a deferral of tax that is not justified and is not available to other businesses, and there can be cases where advantage is deliberately taken of some features of the rules to manufacture a tax advantage. The Government proposes therefore 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.
16. If the outcome of the consultation is that legislation is needed, any necessary legislation will be developed in consultation with the life insurance industry with a view to inclusion of appropriate measures in Finance Bill 2007.

Further advice

17. If you have any questions about this change, please contact Richard Thomas on 020 7147 2558 (richard.thomas@hmrc.gsi.gov.uk) or Colin McHardy on 020 7147 2614 (colin.mchardy@hmrc.gsi.gov.uk). Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk