

## HMRC consultation on life office taxation – Crown Option

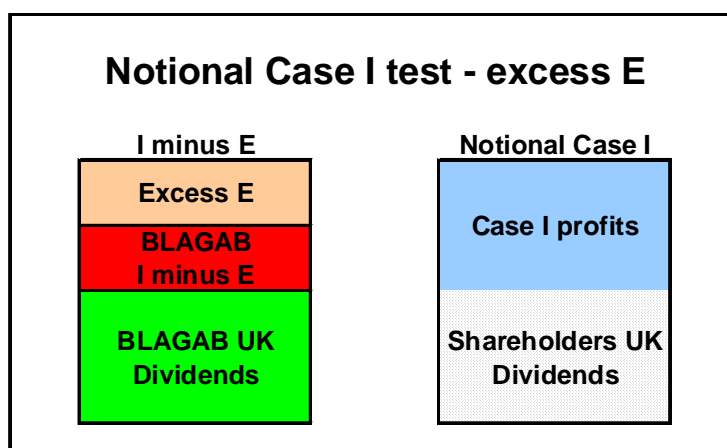
A consultation exercise into life company taxation is currently ongoing, aiming to improve the current I minus E system whilst removing any unnecessary barriers to commercial transactions (especially business transfers). Within scope is the possibility of reforming the Crown Option which we discuss below.

### What is the Crown Option?

The expression I-E refers to the basis of taxation where HM Revenue & Customs (HMRC), in certain circumstances, has the option ('the Crown Option') to tax life assurance business on Investment Income and chargeable gains (referred to as 'I') less expenses (including commissions) (referred to as 'E'). HMRC would normally give notice to a company prior to the revocation of this option, unless concern is expressed about deliberate tax avoidance.

The I minus E result is taxed in two parts; that part deemed to be shareholder profits taxable at 30% and the balance deemed to be policyholder income less expenses taxable at 20%. The shareholder profit is determined using a notional calculation, the Notional Case 1 or "NC1" calculation and is essentially the profit that would be expected to be the increase in shareholder value for the year. HMRC require at least the 30% tax on shareholder profits and so, if the I minus E result is less than the NC1, the expenses are restricted. The restricted amount of expenses is carried forward to future years.

The following diagram indicates the tax calculation where the company restricts its level of expenses it can use in offsetting any taxable income and gains. We have assumed that the company receives UK dividend income which franks part of the shareholders profits that would otherwise be taxable. In addition for simplicity we have assumed that the company only writes Basic Life and General Annuity Business ("BLAGAB").



The "Excess E" is the amount required such that I minus E equals NC1. Currently Excess E cannot be more than the expenses available for the deductible item in the I minus E

It is usually the case that HMRC exercise the option to tax companies on an I-E basis, however it has indicated that it would revoke this option and tax on a pure shareholder profits basis (an "Actual Case I" basis) where the Case I profits exceed the income and gains; even with no deduction for any expenses. Without this change to the tax basis,

HMRC would only be able to tax income and gains (at 30%) and so would not recover tax on the full amount of shareholder profit.

This situation may arise for a variety of reasons, a couple of examples being where:-

- A company may cease to write new business and, as a result of releases of prudential reserving margins, generates substantial amounts of surplus; and
- A company writing mainly certain types of life assurance business that produce little investment income but substantial underwriting profits e.g. term assurances.

### **What are the implications of revoking the Crown Option?**

A revocation of the Crown Option results in an insurance company being taxed solely on an actual Case I basis. The key implications of such a switch in taxation basis are:

- The tax bill for a company can in relevant cases increase significantly;
- Any potential future benefit from carried forward tax assets (such as unrelieved expenses) is permanently lost; and
- UK dividend cannot be used to frank shareholders profits.

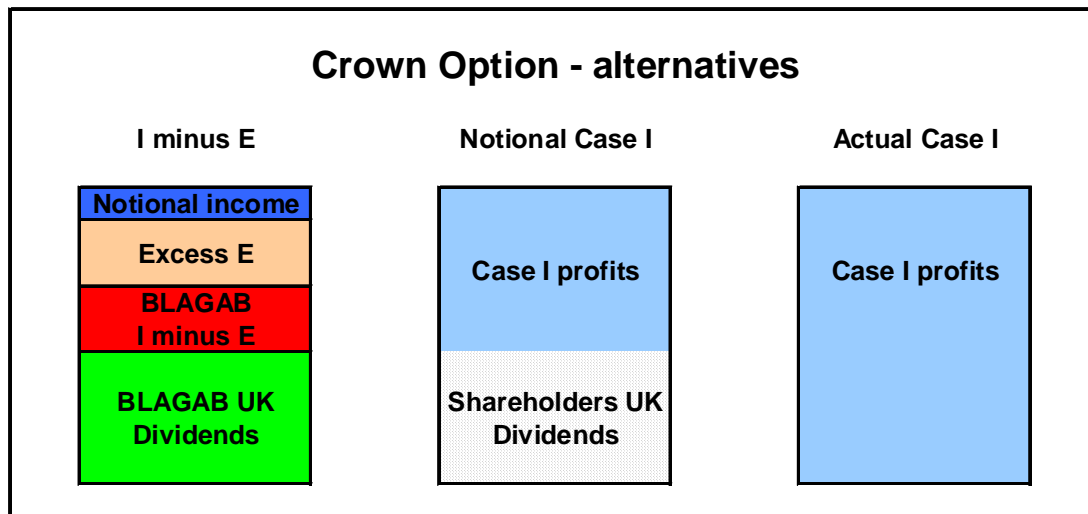
Whilst it is perhaps understandable that HMRC should protect Government revenues, it is hard to understand why the implications of an actual Case I assessment for a company with BLAGAB business should be so penal and any move to make the applicable tax bases more certain would be welcome. The Crown Option is an area where the HMRC has an opportunity to simplify and clarify regulation.

### **What are the alternatives?**

The consultation document briefly considers abolishing the crown option or specifying the circumstances in which it will be applied. The document also invites alternative suggestions.

One alternative currently being discussed, is for companies to increase the level of income by a “notional amount” so that the I minus E gives the same result as Notional Case I profit and then allowing this notional income to be used as an offset to income in future years (and so having a similar effect to carried forward excess E).

This alternative approach is shown in the diagram below:



This would remove the penal impact of switching to an Actual Case 1 basis avoiding concerns in affected companies about potential tax risk whilst allowing HMRC to recover tax on amounts that fully reflect the assessment of shareholders profits.

However, the existing ability of some companies to benefit from tax on income and gains that is less than shareholder profits would be removed because of the action to tax the full amount of shareholder profits through the addition of this notional income.

### What's next?

The tax consultation process continues. We will keep you informed of other developments and implications in future updates.

More detail on this article and previous articles of the Tax Working Party are on our website at [www.actuaries.org.uk](http://www.actuaries.org.uk) under life insurance.

*Matthew Little and Trevor Fannin on behalf of the Faculty and Institute Tax Working Party*