The Actuarial Profession
making financial sense of the future

Richard Thomas
HM Revenue & Customs
100 Parliament Street
London
SW1A 2BQ

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Dear Mr Thomas

Taxation of capital support to long term funds

We note with interest the recent position paper you put forward to the ABI in relation to the taxation of capital support provided by the shareholder of an insurance company into its long term fund.

Our main reason for writing is to voice some concerns identified by our Taxation Working Party over the impact that these proposals might have on the prudent management of long term funds.

Our concerns

The position paper essentially makes the assertion that if a capital injection is provided to make good adverse experience in the fund ("to fill a hole in profits") then such a receipt in the long term fund should be subject to tax.

Our concerns are driven by the asymmetry of the proposals, i.e. that capital injections made into the fund would be subject to tax but that subsequent extractions of that capital from the fund would not be subject to relief. This leads to a situation where a temporary injection increases the tax payable because it is taxed on the way in but not relieved on the way out.

Prudent financial management of a long term fund may typically suggest an injection of capital into a weak fund as a preventative measure against further adverse experience, hoping that such amounts will turn out not to be required and be returned at a later date, rather than leaving capital support until the last possible moment. It is our view that HMRC's proposals may discourage the prudent approach since there will be an overall loss through taxation if an injection is required only temporarily.

Faculty of Actuaries
Maclaurin House
18 Dublin Street
Edinburgh EH1 3PP
Tel: +44 (0)131 240 1300
Fax: +44 (0)131 240 1313
e-mail: faculty@actuaries.org.uk
www.actuaries.org.uk

Institute of Actuaries
Staple Inn Hall
High Holborn
London WC1V 7QJ
Tel: +44 (0)20 7632 2100
Fax: +44 (0)20 7632 2111
e-mail: institute@actuaries.org.uk
www.actuaries.org.uk

Institute of Actuaries
Napier House
4 Worcester Street
Oxford OX1 2AW
Tel: +44 (0)1865 268200
Fax: +44 (0)1865 268211
e-mail: institute@actuaries.org.uk
www.actuaries.org.uk

It is worth noting that provision of capital through contingent loans would not be affected by these proposals at the time such loans were made (or repaid). However, this approach to capital injection is more cumbersome and may not be available in some circumstances, for instance if there are insufficient easily identifiable contingent cashflows to which the loan can attach. Furthermore, there would still be a disincentive for companies subsequently to recognise that support was likely to be permanent in nature and to replace the loans with a simple injection of capital.

Our analysis of the rationale for the proposals

For the reasons stated above, we believe that the proposals may not be in the public interest. However, we also believe that the proposals are not consistent with a fair system of taxation.

The argument used in support of the proposals is an argument of "neutrality" which runs as follows:

- Taxation is based on surplus arising in the fund
- Payments (or provisions) for policyholder benefits are deductible items, i.e. they reduce the taxable surplus
- Amounts injected into the fund increase the total surplus
- Therefore either the injected amounts should be taxed or the policyholder benefits/provisions should not be treated as deductible

However, this argument considers only a small part of the value chain and in particular ignores the shareholder fund where it would be logical for any injection to be correspondingly treated as a deductible item. Otherwise a genuine loss in the long term fund attracts no relief across the company as a whole.

As an example, consider a company with nil surplus within its long term fund and £500 of capital in its shareholder fund. It then makes an operating loss in the long term fund of £100, for which an injection of £100 is required to restore the long term fund to a solvent position.

It seems clear that, as a whole, the company has lost money and ought to be entitled to tax relief, either immediately or through establishment of a loss carried forward. However, the operation of the proposals in the position paper would lead to a nil tax being paid and no losses carried forward.

Suppose the company then makes a further injection of £50 into the long term fund as a prudent step to ensure that the fund remains solvent even if operational losses continue. This payment would be taxed under the proposals. If it subsequently transpired that the losses did not recur, the company would be able to return the excess capital back to the shareholder fund. However, there would only be £36 available for transfer due to the payment of tax (assuming 28%) on the

injection. Overall, the company is back to the position it was in before but has lost £14 directly as a consequence of its prudent management decision.

Our alternative proposals

Tax legislation is of course complex and we are aware that different parties have different views on the interpretation and implications of existing case law. As an actuarial body, we are not best placed to comment on these legal aspects. But it seems to us that a natural starting point must be that movements of capital should be recognised as such and not be subject to tax.

It may be that HMRC have concerns over the deductibility of certain losses in long term funds. But those concerns might better be addressed by challenging the deductibility of the losses rather than by seeking to tax capital injections which are a by product of any perceived "problem", not the cause. We believe that such an approach would deal with any valid abuse in a more logical and targeted way.

We also note that the treatment of transfers of business, which has previously been an area of perceived abuse, has already been dealt with by HMRC through separate new measures.

I hope you find these comments helpful and I look forward to hearing your views on the issues raised.

Yours sincerely

David Hare
Chairman, Life Assurance Practice Executive
The Actuarial Profession

Please reply to Napier House, Oxford