Consultation from the Inland Revenue

Actuarial Profession Life Office Taxation Working Party

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Consultation is a growing phenomenon. It has that appearance of helpful involvement; allowing those bodies that will be affected by a planned change to influence the details of the change and so ease the process for all concerned. However, do respondents know what is in the mind of the draftsmen or draftswomen? What was behind the phrasing of those curiously intriguing passages? Or are we all becoming increasingly paranoid about subtleties included in the changes to the regulatory environment?

The FSA's current consultation program as part of the radical overhaul to regulation of the financial services industry has provided all those in the industry with huge quantities of bedtime reading. However, if you thought that the pace was beginning to ease, the Inland Revenue have come to your rescue.

The Revenue issued its second consultation on the subject of corporation tax in August 2003. Unlike the first consultation that was issued in August 2002, this latest consultation refers to the specific issues and difficulties relating to life assurance.

So change to life assurance taxation is on the way. The key areas of change covered in the documents are:

- Changes to the taxation of capital gains
- Changes to the 'Schedular' system, and
- Changes to the definitions of expense that may be deducted from profits.

Changes to taxation of capital gains

The government believes that current distinction between the taxation of gains and the taxation of income should be removed as far as possible so that tax is more closely aligned with the profits reported in company accounts. The government also believes that indexation relief on capital gains has 'diminishing significance' with inflation at current levels.

For the BLAGAB fund of a life company, where most of the assets are held for the benefit of policyholders, this would suggest that all gains would be taxed on a mark to market basis with no allowance for indexation relief.

The document also states that the object of the special rates of corporation tax on income deemed to be for policyholders' benefits is to reflect, as far as is practicable, the tax treatment of direct investment. Currently, any individual investing in direct shareholdings or though unit trusts or OEICS, would incur capital gains tax only on taxable gains in excess of the personal allowance for the tax year (£7,900) and the balance of the gains, reduced by up to 40% for assets held for over 10 years (taper relief), would be taxed at the individual's marginal tax rate. This basis for taxing capital gains results in very few individuals paying capital gains tax (principally due to the personal

allowance) which contrasts with (until recent falls in stock markets) the routine incidence of capital gains tax in BLAGAB funds.

Bearing in mind both the objectives of the consultation and the intention to be consistent with personal taxation, the document suggests three possible options for the taxation of BLAGAB gains as follows:

- 'Exclude all the remaining capital assets from the new rules;
- Exclude the policyholders share of the remaining capital assets from the new rules leaving those assets within either the existing corporation tax rules for chargeable gains or a modified form of capital gains tax, perhaps offering taper relief instead of indexation; or
- Include all the remaining capital assets within the new rules but adjust the rate of corporation tax on the policyholders' share of gains in a way that reflected the effect of the new rules.'

Comment is invited on these options. However, none of these options appear to approximate to the effective taxation of gains on direct investment by policyholders nor is there any attempt to address the existing differences in taxation between investment through a life assurance policy and investment either through pooled funds or direct investment.

Perhaps a more appropriate approach to taxation of gains would be to exempt the policyholders' share of gains from tax. Individuals that do pay capital gains tax are likely to be higher rate tax payers and so will also be liable to income tax on chargeable gains on termination of non qualifying policies. This exit tax may be the more appropriate vehicle for taxing gains.

The basis for this exit tax could also be reviewed because this tax is intended to apply the full difference between the policyholder rate and the higher rate of tax to all accrued income and gains from April 2004. Again, there is no credit for personal allowances or taper relief on capital gains, although there is a partially offsetting benefit from deferral of higher rate tax on income and there is no grossing up of the investment returns received for the tax already paid at the policyholder rate by the life assurance company.

If policyholder gains were to be made exempt from tax, the taxation of gains deemed to be shareholder gains could more easily follow the treatment applied to other companies.

Review of the Schedular system of taxation

The Schedular system separates profits from a range of sources and taxes the profits from each source separately (i.e. under separate schedules). Losses under one schedule can only be relieved against profits of the same schedule. Consequently, there are a number of corporate groups where there are unrelieved losses in certain tax schedules even though the group has been profitable over all. The system has the convenient effect of increasing the tax take for the Exchequer.

The review of the Schedular system proposes the substantial or complete removal of these artificial tax divisions so that the overall profitability of a corporate group would be taxed.

The Schedular system of taxation is extended for life assurance with a rule that, despite all falling within Case VI of schedule D, losses from pensions, ISA, OLAB and LRB can only be relieved by

future profits in the same category of business. The Revenue has recognised this similarity and it suggests not only combining these four categories of business but possibly also adding PHI business (i.e. critical illness, long term care and income protection business) into the group.

This suggestion seems to be particularly appropriate. It is difficult to rationalise why the launch of a new product, expected to generate losses initially, should be tax disadvantaged due to the deferral of loss relief, if it is the first product sold in one of the categories of business. A similar launch where the product is one of many existing products in the category will be able to relieve initial losses against the profits from existing business.

The proposal to include PHI business is also particularly welcome, since the special tax status of this class of business is a source of significant complexity and confusion. Although PHI business is typically regarded as 'gross' business in proprietary companies, there are significant differences between the taxation of PHI and pensions business. Where the PHI policyholders are members of a mutual company, PHI business is taxed like BLAGAB business which can introduce significant and unjustified differences between proprietary and mutual companies. Ideally the proposal would remove this distinction between proprietaries and mutuals and would also reduce the range of tax rules affecting life assurance companies.

The most intriguing part of the document is the recognition that the I-E system may change though not necessarily as a result of this consultation. The document states that if the system did change, then transitional measures would retain the I-E system for existing business for many years.

The consultation document asks the question 'In, what ways, if any, should schedular reform affect the treatment of life assurance'? We would suggest that combining pensions, ISA, OLAB and LRB would be desirable as would the inclusion of PHI business into this regime. If future BLAGAB business is also to become gross business then this business could also be added and so remove a significant source of complexity.

The ABI has recently surveyed the industry to ask if the I-E system should be terminated. Opinion was roughly evenly divided possibly influenced by the expected ability of companies to relieve all expenses attributed to the BLAGAB fund. However, comments received from respondents also suggested that there was some fatalism about the future prospects for the I-E system and perhaps it would not surprise many offices if this consultation became the catalyst for more detailed consideration of the issues.

Conclusion

The taxation of life business could change radically as a result of this consultation and this may be an opportunity to address the significant differences between the taxation of life business and the taxation of other forms of personal saving which are probably damaging this aspect of the industry.

As with all changes to the tax system, the transitional rules will be important and may even constrain the action that the Revenue can take. Additionally, there are likely to be a number of company specific issues ranging from concerns about obtaining value for existing tax assets to potential administration issues.

Feedback on the consultation has to be submitted by 3 November. Full details of the consultation are available from the Inland Revenue's web site at www.inlandrevenue.gov.uk/consult_new. One

issue that plagues both the Institute & Faculty and the ABI is the diversity of interests within our industry which often make it difficult to comment on proposals with a single voice. If you, or your company, feel strongly about any of these issues, do take the opportunity to comment, and ensure that consultation really works!

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