EXPLANTORY MEMORANDUM TO

THE INSURANCE COMPANIES (CALCULATION OF PROFITS: POLICY HOLDERS' TAX) (AMENDMENT) REGULATIONS 2010

2010 No. 2932

1. This Explanatory Memorandum has been prepared by the Commissioners for Her Majesty's Revenue and Customs (HMRC) on behalf of HM Treasury and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These Regulations amend the Insurance Companies (Calculation of Profits: Policy Holders' Tax) Regulations 2003 (SI 2003/2082) ("the principal Regulations"). The principal Regulations provide that the method for calculating the amount of tax expended on behalf of policy holders or annuitants ("policyholders' tax") is to be determined on the basis used in the company's tax return for the last accounting period which ended before the principal Regulations came into force; or where the company did not exist at the time the principal Regulations came into force, the basis which would have been used if the company had existed at that time. The effect of the principal Regulations is to determine the basis used to calculate the policyholders' tax by reference to the position at the time the principal Regulations came into force. These Regulations make provision for cases where there has been a substantial change in the business of the company and provide that the basis used to determine the policyholders' tax in such cases is that which is just and reasonable.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 These Regulations will apply to periods of account which will be open when the Regulations come into force. Section 82A of the Finance Act 1989 allows Regulations to be made which include provisions having effect in relation to periods of account during which the Regulations are made. For those cases and where the change occurs on or before 31 December 2010 the company will have the option to choose the basis of deduction used for that period and will be able to use either the method that the company currently uses in accordance with the principal Regulations or the just and reasonable basis provided for by these Regulations.

4. Legislative Context

4.1 The principal Regulations provide the basis of deduction for life insurance companies of the tax expended on behalf of its policy holders that is allowable for the purposes of the calculation of profits under section 35 of

the Corporation Tax Act 2009. The deduction is allowed where either it has, or it has been deemed to have, been brought into account.

4.2 The principal Regulations came into force on 1 September 2003 and fixed the basis for the calculation of the amount of policyholders' tax to be that used in the "latest company tax return", that is the return for the latest preceding accounting period of the company which in most cases was the return for the period ended 31 December 2002. Where no basis or return existed, because the insurance company was not in existence at that time, then the method to be used is either that used by the transferor of the business or that which would have been used had the business been required to deliver a return for an accounting period beginning before 1 January 2003.

4.3 These Regulations ensure that where there has been a substantial change to the business of a company, the basis of deduction used by the company is such basis as is just and reasonable and which reflects the current business and structure of the company.

5. Territorial Extent and Application

This instrument applies to the whole of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy Background

- ***What is being done and why***

7.1 The regulation making powers in section 82A Finance Act 1989 under which both the principal Regulations and these Regulations are made were enacted to provide an allowable deduction for tax expended on behalf of policy holders. The need for such a rule derives from the method used in the United Kingdom to charge to tax income and gains accruing to a life insurer for the benefit of policy holders under the so-called "I minus E" method.

7.2 Given that tax is charged on income which will go to policy holders when their policies pay out it is as much an allowable deduction under section 82 Finance Act 1989 in computing a profit under life assurance trade profit rules as claims paid to policy holders.

7.3 Section 82A of the Finance Act 1989 did not define what was meant by the amount of "tax expended on behalf of policy holders or annuitants". Various methods are used by insurance companies from simply grossing up the life assurance trade profit at the ruling rate of mainstream corporation tax to the employment of various formulae.

7.4 In 2003, the principal Regulations came into force and in effect fixed a company's method of calculation to the method used in for the preceding accounting period. Companies not in existence prior to 2003 were required to adopt either the method of the transferor (if their business had been acquired by way of transfer of business) or the method they would have adopted had they been in business prior to 2003.

7.5 The principal Regulations were intended to be "interim regulations" pending the outcome of the consultation with the life assurance industry on the rules that would be contained in primary legislation detailing the method of calculating the policyholders' tax allowable deduction. However, it has not been possible to reach agreement on a formula due to the wide variation in the mix of life assurance business and the differing bases on which insurance companies calculate and account for the amount.

7.6 The problem address by these Regulations is that the principal Regulations do not provide for any alteration to the basis of determination used to calculate policyholders' tax. Many life assurance companies are now very different compared to 2002 following mergers and acquisitions. Therefore it is not appropriate to continue to require life assurance companies to use a basis that was suitable for the circumstances that existed in 2002 but which may no longer be suitable as a consequence of substantial changes to those companies.

7.7 The wholesale changes to the taxation of life assurance companies required under the Solvency II rules mean that any solution (if one could be found) would be short lived. Rather than leaving insurance companies in the same situation until the Solvency II changes come into effect in 2013 as an interim approach the principal Regulations are being amended to require that where there has been a substantial change to the business of a company, the basis used to determine the policyholders' tax deduction is just and reasonable having regard to the insurance company's circumstances.

7.8 The insurance industry and the Association of British Insurers have considered these Regulations in draft and are comfortable with both the content and the terminology used, being words and phrases that are in common use within the life assurance businesses.

- ***Consolidation***

7. 9 It is not intended to consolidate the Regulations at this time.

8. Consultation outcome

These Regulations were considered by the life assurance industry in November 2010 as part of the ongoing informal consultation process between HMRC and Life Insurance companies. There was support for the approach taken.

9. Guidance

HMRC have worked with the industry to develop joint guidance on the calculation of policyholders' tax. This will be published in HMRC's 'Life Assurance Manual'.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible.

10.2 The impact on the public sector is nil.

10.3 An Impact Assessment has not been produced for this instrument as it has a negligible impact on business, charities or voluntary bodies.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

Review of the effects of the measure will be ongoing from the date on which these Regulations come into force (31 December 2010) as part of the Large Business Customer Relationship management process. All life assurance companies are dealt with by the Large Business Service within HMRC.

13. Contact

Carol Johnson at HM Revenue and Customs Tel: 020 7147 0517 or email carol.johnson@hmrc.gsi.gov.uk can answer any queries regarding the instrument.