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INVESTMENT BONDS EFFECTED BY COMPANIES

The taxation treatment of corporately owned life policies following publication of the Finance Bill

Special considerations

As announced in the 2007 Pre-Budget Report, the application of the loan relationship rules to all investment life insurance contracts (largely investment bonds) from 1st April 2008 means, broadly speaking, that annual investment gains made under UK and offshore investment life insurance contracts will be taxed as non-trading credits under the loan relationship rules. The original position, as set out in draft legislation, changed in a number of important areas following the publication of the Finance Bill 2008. This article is based on the Finance Bill provisions and, in producing this, we are grateful for the assistance we have received from HM Revenue and Customs (CT and VAT Division) in clarifying the application of these provisions.

It seems clear that, in practice, how policies will actually be taxed under the loan relationship rules depends on what basis of accounting the company adopts. In this respect a company will generally adopt a fair value approach but, in cases where the FRSSE (Financial Reporting Standard for Smaller Entities) applies, a historic cost basis can be adopted. This is important in the context of the loan relationship rules as it is generally thought that the majority of companies who own or would be interested in investing in a life policy would satisfy the definition of small company, to which the FRSSE can apply, and most of these would adopt a historic cost basis. A company is a small company for this purpose if it satisfies 2 of the following 3 requirements:

(a) Turnover is £6.5 million or less
(b) Balance sheet total is £3.26 million or less
(c) The average number of employees is 50 or less

The relative position of companies that adopt “fair value” and “historic cost” are considered below:

(a) Fair value basis

For companies which adopt a fair value basis of accounting, the increase in the value of the policy that arises over an accounting period will be taxed as a non-trading credit (NTC) under the loan relationship rules. This increase will be, in effect, the difference between the surrender value of the policy at the beginning of the year and the surrender value at the end. Where the company has a policy that was owned at the start of the first accounting period starting on or after 1 April 2008, the value of the policy will be determined at that date to determine the chargeable event gain that has arisen up until the policy enters the loan relationship rules. That gain will not, however, be taxed until the policy is finally encashed when it will, in effect, “inflate” the NTC at that point. This is covered in more detail below.

Where a company invests in a UK life policy (or an EEA life policy suffering a UK equivalent rate of tax) the year by year amount on which the company will be taxed under the loan relationship rules will reflect the net profit arising under the policy after internal life company tax of 20%. This would mean that there could be an element of double taxation.

To deal with this problem, the Finance Bill provides for the amount subject to tax under the loan relationship rules to be increased, ie grossed up, to reflect the tax suffered at UK life company level, currently at the rate of 20%. But, contrary to what was originally thought, this **grossing up** will not happen each year. In this respect, the Finance Bill introduces a special rule to ensure that, on final encashment of the policy, a 20% tax credit is given for the NTCs (deemed gains) chargeable under the loan relationship rules **over the whole period of ownership** (or the period of ownership from the start of the first accounting period beginning after 31 March 2008 if the policy was owned at that time) and not simply the gain for the accounting period in which the policy terminates. It is probably best to consider how this operates by looking at an example.

Jagger Ltd effects an investment life insurance contract for £100,000 with the Old Rocker Insurance Company Ltd on 1 July 2008 at the beginning of its accounting period. Fair value is therefore £100,000. Jagger Ltd pays corporation tax at 28%.

(i) At 30 June 2009 fair value is £105,000 so the NTC = £5,000
(ii) At 30 June 2010 fair value is £112,000 so the NTC = £7,000
(iii) At 30 June 2011 fair value is £120,000 so the NTC = £8,000
(iv) At 30 December 2011 the policy is fully surrendered for £125,000

The amount of corporation tax payable by Jagger Ltd is as follows:-

(i) £5,000 @ 28% = £1,400 (financial year 2009)
(ii) £7,000 @ 28% = £1,960 (financial year 2010)
(iii) £8,000 @ 28% = £2,240 (financial year 2011)

The final surrender of the policy is a "related transaction" and so the rules in Schedule 13 Finance Bill 2008 apply. First, it needs to be noted that on the final surrender there is a NTC of £5,000 for that accounting year. As the company adopts a fair value basis of accounting, the tax treated as paid must be calculated in accordance with para 4 Sch 13 Finance Bill 2008.

To do this it is necessary to ascertain PC, which is the "profit from the contract". This is the total of all NTCs to date and in this case amounts to £25,000 (£5,000 + £7,000 + £8,000 + the final £5,000). The relevant amount is 25% of PC (ie PC grossed up by 20%), which amounts to £6,250.

The NTC in the last accounting year is therefore treated as increased to £11,250 (£5,000 plus £6,250). Corporation tax is 28% x £11,250 = £3,150, and tax treated as paid of £6,250 is available to be set-off against this and any other corporation tax assessable on the company for the period.

When a policy is owned at the start of a company's first accounting period which begins after 31 March 2008, a deemed full surrender is treated as having taken place immediately before the start of that accounting period. No tax charge arises then on the deemed chargeable event gain, but it is brought into charge to tax and taxed as a NTC when the policy terminates. In calculating the deemed chargeable event gain, the carrying value in the accounts is used for a company adopting a fair value basis of accounting. There is no credit for basic rate tax suffered within the life fund for the NTC derived from the deemed full surrender. Detailed rules are included in the Finance Bill to prevent inequitable results where the policy has suffered a reduction in value or large withdrawals have previously been made.

(b) Historic cost basis

Where the historic cost basis is adopted, an investment life insurance contract will be taxed as follows:-

(a) there would be no NTC arising by virtue of an increase in the actual (surrender) value of the policy in any year and so no actual charge to corporation tax could arise under the loan relationship rules until a "related transaction" eg. surrender or part surrender took place;

(b) this means that a charge to corporation tax would not arise until an actual encashment or part encashment of the policy took place when the "real" realised gain would be subject to corporation tax as a NTC; and

(c) for a policy with a UK insurer (or one with an EEA insurer that has suffered a comparable EEA tax charge) at the time of the "related transaction", the NTC would be increased as indicated in para 3 Sch 13 Finance Bill 2008 and the corporation tax assessable on the company would be reduced by the increase resulting from the formula in para 3(3) Sch 13.

In other words, if a historic cost basis of accounting is adopted:

(i) a deemed chargeable event gain under para 6 Sch 13 would be avoided when the policy comes into the loan relationship rules, and

(ii) there would be no future NTCs "year-on-year" under the loan relationship rules, and

(iii) a tax liability could only arise when an encashment or part encashment actually takes place. At this point there would be the usual grossing up and credit process for a UK or EEA "comparable rate" company.

For companies which owned policies before 1 April 2008 (or the start of their first relevant accounting period after 31 March 2008) and which are assessed on the historic cost basis there would be no deemed chargeable event gain at the commencement of the first accounting period starting after 31 March 2008. This is because the measure of the deemed gain is the carrying value for accounting purposes – which will be the historic cost. On a related transaction (eg final surrender) the gain (NTC) will be measured by deducting the original investment (historic cost) from the amount realised from the full encashment. The whole of the NTC derived on final surrender would be grossed up by 20%, even though some of it will be derived from the period before the loan relationship rules came into effect. So for example:-

Richards Ltd, whose accounting period runs from 1 September to 31 August, effected an investment bond policy with the Stone Roller UK insurance company on 1 May 2001, paying a single premium of £100,000. The company operates on a historic cost basis. On 12 October 2012, it surrenders the policy for £300,000.

The tax implications of this are:-

(i) Although the policy comes into the loan relationship rules on 1 September 2008, there is no annual NTC to bring into charge because the company operates on a historic cost basis.

(ii) On 12 October 2012 the NTC is calculated as follows:

Amount received on final surrender	£300,000
Less amounted invested (premium) in 2001	£100,000
NTC	£200,000

(iii) The amount of the NTC (£200,000) is grossed up in accordance with paragraph 3 Schedule 13 by the (AR /(100 –AR) x NTC) formula in paragraph 3(3).

In the example we are using the NTC would thus increase to £250,000. This means that if the investing company were, say, a 28% taxpayer, the corporation tax would be £70,000 (28% of £250,000) but this would be reduced by the tax credit of £50,000 to £20,000 – and this would be the amount of corporation tax payable.

SPECIAL CONSIDERATIONS

(i) Pre-14 March 1989 policies

Life policies effected by a company before 1989 (and which have not been subsequently enhanced as to benefit or term) were already outside the chargeable event legislation and they also fall outside the loan relationship legislation.

(ii) Commercial mortgage arrangements

Subject to the satisfaction of certain conditions, under the previous legislation an endowment policy effected by a company as part of a commercial mortgage arrangement would not have given rise to a chargeable event gain on maturity or the payment of death benefits. The Finance Bill makes no reference to this rule which means that, as things stand, the annual gain on such policies will be brought into charge to tax under the loan relationship rules unless they are pre 14 March 1989 policies which have not been subsequently enhanced (see (i) above).

(iii) Capital redemption policies

Capital redemption policies were for the most part brought within the loan relationship legislation in February 2005. The draft legislation in the Finance Bill defines an “investment life insurance contract” as including capital redemption policies so that corporately owned capital redemption policies effected before 14 March 1989 and not subsequently enhanced will also fall outside the loan relationship rules.

(iv) The position on death

The mortality element of gains will be ignored because in calculating the non-trading credit (ie the annual gain for loan relationship purposes) the surrender value immediately before death is to be used and not the sum assured actually paid. This rule is extended to cover critical illness benefits.

COMMENT

It is worth observing that, given the relatively well-known double taxation under the previous chargeable event provisions when a company invested in a UK bond (with tax due at fund level and on encashment, with no credit for life fund tax), there may be relatively few cases where UK companies had UK bonds in force before 1 April this year.

FINANCE BILL 2008 AND PENSIONS

The Government has issued three sets of draft regulations which will tie in with new legislation included in the Finance Bill 2008. These cover:

1. New Authorised Payments Regulations

As announced in the 2007 Pre-Budget Report, and as set out in the Finance Bill 2008, the Government has extended the range of small payments which do not attract unauthorised payment charges beyond those covered by the existing trivial commutation rules.

Such payments will be set out in regulations under section 164(1)(f) of the Finance Act 2004, newly created by Schedule 29 Finance Bill 2008. In late May the Government issued a draft of theses regulations, the Registered Pension Schemes (Authorised Payments) Regulations 2008. These set out details of the payments involved. They include the conditions to be met for the new £2,000 de minimis triviality payment applicable under occupational schemes.

These regulations are not solely concerned with triviality and also define circumstances where benefits falling within the new section 164(1)(f) can be treated either as pension payments or a pension commencement lump sum (PCLS).

2. Transfer of Sums and Assets Amendment Regulations

These draft amending regulations to the principal Transfer of Sums and Assets Regulations (SI 2006/499) ensure that where the obligation to pay a lifetime annuity or a dependant's annuity has been transferred from one insurance company to another the transfer will not be treated as an unauthorised member payment by virtue of being a surrender of a member's rights to receive payments under the original annuity (ie in accordance with section 172A of the Finance Act 2004). However, this is only to the extent that the funds transferred from one insurance company to another are applied to the payment of the new annuity. The regulations achieve this by treating the new annuity as if it were the original annuity.

3. Inheritance Tax (Qualifying Non-UK Pension Schemes) Regulations

Before 6 April 2006 protection from inheritance tax charges applied to certain superannuation schemes. As well as UK pension schemes, this could also include pension schemes that were established overseas. The Finance Act 2004 introduced significant changes to the tax regime for pension schemes, which took effect from April 2006. As part of these changes protection from inheritance tax charges was restricted to registered pension schemes and section 615(3) schemes. It no longer, therefore, applied to schemes established overseas that were not pension schemes registered in the UK. The policy intention was to limit the inheritance tax protection to pension schemes that were tax-recognised and regulated. It was not intended to remove the protection entirely from all non-UK pension schemes.

The amendments made by the Finance Bill 2008, together with these regulations made under section 271A Inheritance Tax Act, will, as intended, restore the inheritance tax protection to certain non-UK pension schemes that are broadly equivalent to registered pension schemes.

PENSIONS MISCELLANY

- Last summer HMRC announced its intention to bring into tax in 2007/08 some small private pensions paid by employer pension schemes or insurance companies, which commenced prior to 6 April 2006 and which had not been properly taxed under PAYE. HMRC has now confirmed that such pensions will not be brought into tax until 2008/09.

- The Pensions Regulator has issued guidance for trustees covering their relations with advisers.

- The PPF Board has announced that the scaling factor, used in calculating the risk-based levy, will be 3.77, more than double its estimate of last autumn and just over a 50% increase on the 2007/08 factor of 2.5. In 2006/07 the factor was just 0.5. The sharp rise in the scaling factor is a result of two main changes:

    - *Improved funding levels*. Ironically, this itself is an indirect consequence of the credit crisis, which has pushed up corporate bond yields and thereby reduced liabilities. When making its initial estimate for 2008/09, the PPF estimated aggregate scheme deficits at £48bn, but by the time the PPF finalised the factor, these had fallen to £28bn.

- *Reduced scheme failure risk*. Many employers have taken direct action to reduce insolvency risk, not least with the aim of reducing their PPF levy payments.

The increase in the levy scaling factor has caused cries of pain because defined benefit (DB) schemes had been working on an assumption that the final figure would not vary much from the initial estimate and are now faced with a 135% increase. There is a danger that if deficits continue to shrink and insolvency risks keep falling, the whole concept of a risk-based levy, based on potential PPF shortfalls, will become unsustainable.

CONTRACTED OUT BENEFITS

June saw a number of major announcements regarding contracted out benefits as follows:-

a) The Government announced that the current Pensions Bill will be amended to abolish the protected rights "survivor's benefit" rule. This rule currently requires an individual with a spouse or civil partner, at the point of annuitisation, to use any protected rights benefits to purchase a joint life annuity. This change will be made at the same time as money purchase contracting out ceases (ie. expected to be in 2012).

b) The latest (33rd) National Insurance Services to the Pensions Industry (NISPI) Newsletter indicates that the intention is that from April 2009 GMPs can be converted into ordinary scheme benefits. Although the ability to convert GMPs had been set out in the Pensions Act 2007 no date had been given for this and the regulations confirming how this can be done are still awaited. This proposed commencement date has been confirmed in a note issued by the DWP setting out the pensions consultations/regulations it expects to issue during this financial year. This note also confirmed that the draft conversion regulations should be issued in July 2008.

c) The above DWP note also indicated that the Appropriate Schemes and Protected Rights Amendment regulations should be issued by 30 June 2008. These regulations will follow the consultation, which ended on 29 February 2008, and will enable all SIPPs to hold protected rights benefits with effect from 1 October 2008.

THE PENSION CREDIT

Draft changes to the pension credit rules

HMRC is consulting on the draft Pension Sharing (Pension Credit Benefit) (Amendment) Regulations 2008. These amending regulations are designed to align the rules for payment of pension credit rights, resulting from a pension share, with other benefits held under an occupational pension scheme. It is proposed that these regulations will come into force on 1 October 2008.

The amendments will enable pension credit benefits held in an occupational pension scheme to be paid from age 50 (55 from 2010). The amendments will also enable a pension commencement lump sum to be paid in respect of such benefits at any age where permitted by the simplified tax regime rules.

These regulations only apply to occupational schemes as there are no comparable restrictions applicable to personal pensions. These changes, however, do not apply to safeguarded rights benefits. The Pensions Bill 2007 includes provision for the abolition of safeguarded rights and it is intended that the Safeguarded Rights Regulations (SI 2000/1055) will be revoked when abolition takes effect. The DWP's intention is that the abolition should be around October 2008 to tie in with these changes but there is no guarantee of this date. If the safeguarded rights benefits have not been abolished by the time these amending regulations take effect it should be remembered that the restrictions applicable to safeguarded rights will continue to apply. This will mean safeguarded rights benefits under both occupational and personal pension schemes will not be able to be drawn before age 60, and that no commutation of safeguarded rights benefits will be permitted.

THE FINANCIAL ASSISTANCE SCHEME (FAS)

The Financial Assistance Scheme (Miscellaneous Provisions) Regulations 2008 have been laid

These regulations introduce the first tranche of the improvements to the FAS, which were announced by the Government on 17 December 2007. These regulations implement the main changes included in the 17 December improvement package. These are:

- To increase the FAS payments for all qualifying members. This will ensure such members are guaranteed 90% (rather than 80% as previously applied) of their accrued pension at the date of commencement of wind up, revalued to their retirement date (subject to a cap of currently £26,000, the value of which will be protected). Survivors of qualifying members will receive a benefit of 50% of the qualifying member's entitlement.

- The FAS benefits will be paid from the member's Normal Retirement Age (ie. the age specified in the rules of the qualifying scheme at which the member will normally retire) where this is between age 60 and 65. Where the Normal Retirement Age (NRA) is outside this range the benefits will be paid from age 60, where the NRA is lower than this, and from age 65 where the NRA is higher than this. However, payments will not be made for periods before 14 May 2004 (ie. the date the FAS was first announced).

The Government has set out its response to the consultation on the second set of draft regulations to implement the changes to the FAS it promised on 17 December 2007, and laid a draft of these proposed regulations before Parliament on 18 June 2008. It is intended that these regulations should come into force before Parliament recesses in July.