EXPLANATORY MEMORANDUM TO

THE AUTHORISED INVESTMENT FUNDS (TAX) (AMENDMENT No. 3) REGULATIONS 2012

2012 No. 3043

1. This explanatory memorandum has been prepared by HM Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 To correct an inadvertent effect of a change to the Authorised Investment Funds (Tax) Regulations 2006 following the tax law rewrite process. The regulations restore the previously intended tax treatment of dividend distributions made by Authorised Investment Funds (AIFs) and received by life insurance companies as part of certain long term insurance business where returns are normally taxed (if applicable) only in the hands of the policyholder.

2.2 In particular, by restoring the application of the 'corporate streaming rule' that gives credit for tax incurred by the AIF by treating part (or all) of any dividend distribution received by a company within the charge to CT as being an annual payment made under deduction of basic rate income tax.

2.3 The purpose of giving credit for the tax by the AIF is to ensure that tax in the insurance fund (or the AIF) does not reduce the return to the policyholder.

2.4 The tax treatment described here applies only to certain types of insurance business.

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

3.1 None.

4. Legislative Context

4.1 The need for change arises through an inadvertent effect of updating the Authorised Investment Funds regulations following the tax law rewrite process. The change was to the wording of regulation 48(2A) where the words "Chapter 2 of Part 3 of CTA 2009" were substituted (by SI 2010/294) for "section 95 of ICTA or section 219(4) of FA 1994".

4.2 The purpose of the change was to ensure that regulation 48 continued not to apply to any dividend distribution that was on trading account. In the

case of corporate investors chargeable to tax on distributions as trading income then regulation 48 is not relevant and not required. Paragraph (2A) was originally inserted by SI 2008/3159 following the disclosure of avoidance schemes to create artificial tax credits, and then the current words were substituted by SI 2010/294 to take account of tax law rewrite changes to primary legislation.

4.3 Section 95 ICTA 1988 defined ‘financial traders’ and contained a specific exclusion for insurance companies from such a definition. The change made in 2010 did not replicate that exclusion so that on its face regulation 48 no longer applied to certain types of insurance business when the policy intention was that it should continue to do so. This unintended effect of the change has only been identified very recently.

4.4 This instrument restores the previous taxation position for insurance companies in receipt of distributions from authorised investment funds.

5. Territorial Extent and Application

5.1 This instrument applies to all 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 corporation tax rate applying to AIFs is equal to the basic rate of income tax has historically been, and remains, lower than the corporation tax rate. Regulation 48 exists to prevent corporate investors using authorised investment funds (AIFs) to obtain a lower rate of taxation on taxable investment income than they would get by direct investment.

7.2 Regulation 48 does not apply to financial traders. They are taxed in full on dividend distributions as trading income. The pre tax law rewrite exclusion for financial traders in regulation 48(2A) pointed to section 95 ICTA 1988 which had not included insurance companies whereas chapter 2 of Part 3 CTA 2009 (which has replaced section 95 ICTA 1988 in regulation 48(2A)) does include certain business of insurance companies. In many respects this is correct – that is where an insurance company is taxable as a financial trader the same treatment should apply, but insurance industry representatives have pointed out that one specific type of insurance business requires the operation of the corporate streaming rule in order to give the intended tax result for policyholders.

7.3 The type of insurance business affected is non-BLAGAB long-term business (Under the new tax regime for life insurance companies introduced in the Finance Act 2012, which will have effect from 1 January 2013, long-term business will fall, for tax purposes, into one of two categories. These are basic life assurance and general annuity business (BLAGAB), and non-BLAGAB.) This type of business generates returns for the types of policyholders who will generally not be taxable. It includes pension business where it is the later annuity that will be taxed, ISA business that is tax free by Government policy and overseas life assurance business where the policyholder is not UK resident.

7.4 This part of an insurance company's business is taxed on the basis that all income, including premiums, is taxed as trading income so amounts paid out to policyholders are deductible expenses. This has the intended result that returns to policyholders are free of tax in the insurance company. The trade profit made by the insurance company is what is ultimately taxed. Where the dividend distribution from an authorised investment fund is derived from taxable income in that fund and subject to tax in the fund then the policyholder suffers underlying tax that would not apply if they had invested directly in the assets held by the fund. This is not and never has been the intention. Corporate streaming prevents this happening.

- ***Consolidation***

7.5 There are no plans to consolidate the revised Regulations in the immediate future.

8. Consultation outcome

8.1 HMRC has consulted informally with the insurance industry and investment managers once this issue was identified. However, the full formal consultation period has not been possible due to the need to rectify the inadvertent change quickly.

8.2 The corrections have been discussed with representatives of the insurance industry and investment managers. All parties were satisfied that the regulations will work as intended.

8.3 Industry accepts that this instrument is simply restoring the previous position following an unintentional change so there is no difference in the underlying policy rationale.

9. Guidance

9.1 Guidance is already available on the HMRC website as this instrument is only correcting an inadvertent change to current legislation.

10. Impact

10.1 The regulations affect the life insurance sector only (approximately 250 companies). There is no impact on charities or voluntary bodies or the public sector.

10.2 An Impact Assessment has not been prepared for this instrument.

11. Regulating small business

11.1 The legislation applies to small businesses.

11.2 The regulations may affect approximately 30 Friendly Societies classified as small firms (that is, with fewer than 20 employees). These have to be included as they are part of the life insurance sector. Affected taxpayers have continued to apply the previous practice which was also in line with HMRC guidance, and so these Regulations will not have any impact.

12. Monitoring & review

12.1 HMRC has an established programme of liaison with the life insurance industry, which will capture issues around implementation and ongoing compliance. No special data should be needed for monitoring; tax returns will provide the information required to make an assessment of the tax impact of these regulations.

13. Contact

John Buckeridge or Tina Jacob at the HM Revenue & Customs Tel: 0207 147 2560 or 0207 147 0517 or email: john.buckeridge@hmrc.gsi.gov.uk or christina.jacob@hmrc.gsi.gov.uk can answer any queries regarding the instrument.