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FRIENDLY SOCIETIES

The Economic Secretary thought the Prime Minister should know that action has become necessary to deal with serious legal doubts over the validity of some 300,000 insurance contracts made by Friendly Societies with their members. He intends to announce tomorrow that the Government will introduce legislation to reassure policy holders and clarify the tax position for future friendly society business. All parties concerned - societies, their members, the Registry of Friendly Societies and the Revenue - have been acting on the basis of the law as it was previously understood to be. The Economic Secretary, with the approval of the Chancellor, considers that it would be unacceptable for 300,000 people who entered into contracts in good faith not to get the return they were led to expect on their investment. The need for legislation is confirmed by the Law Officers, and QL have agreed to a short validating Bill at the beginning of the 1984-85 session. A draft of the proposed Treasury press notice is enclosed.

Most of the background is set out in the draft press notice. The Registry of Friendly Societies consulted Treasury Junior Counsel in the first place because certain friendly societies were planning to exploit what they thought was an avoidance route, to circumvent the reduction in the limits on the size of their tax-exempt policies introduced in the Budget to counter abuse. Counsel and the Law Officers not only confirmed that the avoidance route was illegal, but were also led to the conclusion that many existing policies were ultra vires and probably void.

The content of the proposed legislation should not be controversial, since it validates existing policies and their tax treatment, along the lines investors, friendly societies and the Revenue believed to apply at the time the contracts were made. As for future business, it establishes a clear tax

Prime Minister (2)

To note that the Treasury will announce tomorrow that legislation is to be introduced to clarify the law on insurance contracts made by Friendly Societies. Legal advice is that many existing policies may be ultra-vires.

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regime, which is essentially that which was intended when the Chancellor changed the limits in the Budget. The tax provisions will be in the Finance Bill 1985, so that the validating legislation can be kept to the absolute minimum.

Unlike traditional friendly societies, the eleven friendly societies directly affected were set up since 1966 for commercial purposes. They will clearly be disappointed that their potential avoidance route has been closed, but they ought to welcome the ending of uncertainty over the business they are entitled to do, which has lasted since mid-April when the Registry put them on notice that the avoidance route was suspect. They will also benefit from removal of impediments to their doing taxable life assurance business, which are no longer needed.

The traditional friendly societies will be largely unaffected, but like the life companies they ought to be glad that the "commercial" societies will not be able to circumvent the Budget limits.

One measure the societies will dislike is the application to all future friendly society annuity contracts of the rule, which already applies to all insurance companies' annuity contracts, that the surrender of an annuity for a capital sum is a "chargeable event" which may give rise to a tax liability. This is, however, essential if this avoidance route is to be permanently closed. Its effect on the traditional societies will be very limited, since they sell genuine annuities, not for the purpose of tax avoidance. Surrenders of genuine annuities are rare, and the tax charge will relate only to the amount by which the surrender value exceeds premiums paid - in a good proportion of cases it will not do so. Existing policies will not be affected and we do not believe that significant hardship for individuals will occur in future.

There is also a possibility of a critical analogy being drawn with the change in the tax treatment of gilts held by building societies. In both cases, a significant change from what had hitherto been the generally accepted understanding of the law was proposed following advice from Counsel. But the parallel is misleading in that in the present case the Government is legislating to restore the law broadly to what it had been understood to be, in order to protect investors.

The critical point in presentation will be to reassure existing investors that their contracts are safe and that the relevant tax exemption of the societies is confirmed at the same time as the problem comes to light. To achieve this the Government must take the initiative with an announcement, and avoid a situation in which the doubts become public first, and the Government then appears to be reacting to a loss of confidence.

Societies have been pressing the Registry for a definitive view on the avoidance route, as well as consulting their own Counsel. It is likely that at least some have by now correctly guessed

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the substance of the legal advice to the Government. The Press are aware that the societies are holding back from marketing certain policies, awaiting the outcome of their discussions with the Registry. There is an increasing risk of the matter becoming public and the Government losing the initiative. For all these reasons it is essential to announce the measures as soon as possible.

The announcement will no doubt lead to a more extensive debate on Clause 71 of the Finance Bill (which deals with friendly society limits) than might otherwise have been the case. This will probably take place in the second week after the ~~budget~~ ~~speech~~ but the debate in Committee would have been on a false basis if the announcement had not already been made.

The Economic Secretary had hoped that it would be possible to make an announcement by written answer before the House rose for the short recess. But it did not prove practicable to settle the technical details of the new tax regime in time.

I am copying this letter to the Private Offices of Members of QL, the Secretaries of State for Northern Ireland, Scotland and Wales, the Governor of the Bank of England and Sir Robert Armstrong.

Yours sincerely  
A M Ellis

A M ELLIS  
PRIVATE SECRETARY TO THE  
ECONOMIC SECRETARY

DRAFT

PRESS NOTICE - HM TREASURY, 31 MAY 1984

Mr Ian Stewart, MP, Economic Secretary to the Treasury, announced today that the Government will introduce legislation as soon as practicable to protect the position of holders of certain life insurance contracts already made by friendly societies, about which serious legal doubt has arisen, and to resolve uncertainties about the tax rules relating to the future life assurance business of friendly societies more generally. These proposals will have immediate effect from midnight tonight.

2. Commenting on the Government's proposals, Mr Stewart said:-

"There are two main aspects to these proposals. The first concerns the validity and tax treatment of policies which have been taken out in good faith by 300,000 policy holders in recent years. The second concerns the business which friendly societies will be permitted to do in future, and the limits applicable to tax-exempt policies. The Government decided that it was right to act promptly to resolve the problems which had arisen in both these areas.

Let me emphasise that the policy-holders affected have no cause to worry. The legislation will include provisions which will place their policies in the same position as they had previously believed them to be. Policy-holders and friendly societies will therefore continue to receive the favourable tax treatment that they expected when the policies were taken out.

As regards the future, it is necessary to remove the doubts which have arisen about the legitimacy and tax treatment of various kinds of policies issued by friendly societies. In particular the application of the tax-exempt limits is now to be clearly defined. One consequence is that it will no longer be necessary to restrict the business of societies established since 1966 so tightly, and they will now be permitted to issue endowment as well as whole life policies. They will also be able to offer policies to all adult members and not just to those with dependents, as has been the case up to now.

I hope these provisions will enable the societies to resume and develop their life assurance business with confidence after a period of uncertainty."

How the problem arose

3. Following the revised limits for friendly society business proposed in the 1984 Finance Bill, a number of friendly societies announced plans to market investment schemes which would combine a whole life contract with a contract for an annuity which was intended to be surrendered for a gross sum. The result of this would have been a combination of policies which exceeded the new statutory upper limit of £750 on the gross sum assured and appeared to circumvent the reduction in the upper limit for tax-exempt societies announced in the Budget.

4. The Registry of Friendly Societies accordingly sought legal advice about the validity of these proposed contracts. This advice makes it plain that many contracts made by friendly societies formed since 1966 that were intended to be tax-exempt are in fact of highly doubtful validity, even though they were entered into in good faith by both the friendly societies and the members concerned. The Government does not believe it would be in the interests of friendly societies or their members to allow uncertainty to continue for a long period until the position under the present law could be tested in the Courts. (The law at present governing the life assurance business of the friendly societies is contained in Sections 7 and 64 of the Friendly Societies Act 1974 and Sections 332-337 of the Taxes Act 1970.)

The current position

5. The life assurance business of societies established after 1966 is restricted to three categories:-

- i) industrial assurance;
- ii) certain kinds of mixed sickness/whole life assurance;
- iii) contracts exclusively for the payment of an annuity or lump sum on the death of the member for the benefit of a spouse or dependent children.

This restriction has to be written into the rules of a society if it is to obtain tax-exemption on its life assurance business. Before the Budget, societies restricting themselves to writing tax-exempt business benefited from higher exemption limits than those applicable to societies which also wrote taxable business. In the Budget this preferential treatment was removed, and a single limit made to apply to the tax-exempt business of all societies. Although the business of post-1966 societies remained restricted to the same three categories, as a result of the Budget the relative disadvantage they suffered previously from writing taxable business was removed.

6. The category of business conducted by post-1966 societies which led the Registry to seek legal advice is (iii). The societies concerned have included in their rules the necessary restrictions mentioned above, and their formal policy documents have complied

strictly with their rules. But in promotional brochures, the societies have marketed such policies as investment or endowment contracts for the benefit of the holder, on the basis of their surrender value after 10 years. The Government's legal advisers have confirmed that such brochures have to be regarded as part of the totality of the contracts to which they relate. This means that the contracts as a whole do not comply with the societies' rules, which do not permit them to issue endowment policies designed as such. Because of this, these contracts are almost certainly ultra vires, and may not therefore be fully enforceable.

7. It also follows from the advice received by the Government that in the case of annuity contracts which entitle the member to a lump sum on surrender, that sum must be added to any other gross sum to which the member is entitled under a friendly society policy, for the purpose of applying the statutory limit on a policy-holder's entitlement. It clearly follows that, under the combined investment schemes the societies' were proposing to market, the statutory lump sum limit would have been exceeded, since the limit applies to the combined lump sum, and not individually to the sum assured under the gross sum policy and the lump sum intended to be payable on surrender of the annuity. Many of the policies would therefore not only have been ultra vires if issued, but also in excess of the tax-exempt limit.



8. The Government's legal advisers further concluded from a detailed examination of the statutory limitation in Section 64 of the Friendly Societies Act, that many of the investment-linked tax-exempt contracts made over a long period by post-1966 Friendly Societies and, possibly, by some other societies, are likely to have exceeded the statutory limits for tax-exempt policies, by virtue of giving an entitlement to receive a gross sum in excess of the limit on surrender of the policy after ten years. The assumption had been that any increase in the value of an investment-linked policy over the basic gross sum assured should be treated in the same way as the bonus on a with-profits policy which Section 64 allows to be disregarded. But the Government's legal advice now is that it cannot be so disregarded, and the tax-exemption of these investment-linked policies is therefore put in doubt.

#### Validation of existing policies

9. Some 300,000 policy holders have in good faith taken out policies which may be void for the reasons set out above. So far as existing policies are concerned, the purpose of the legislation now proposed is therefore to validate and restore tax-exemption to contracts, which solely for those reasons, appear to be ultra vires and/or in excess of the tax-exempt limits. This validation will apply to all relevant existing policies issued in respect of contracts made before midnight tonight. Legislation will confirm that such contracts are tax-exempt, provided that:

- a) the gross sum assured, or the annual payment assured under the annuity as the case may be (in either case exclusive of any additions derived from investment-linking), is within the limits applicable at the time at which the contract was made; and
- b) the policy is not subsequently enhanced, whether or not by the exercise of an option.

#### Future tax treatment and application of limits

10. Legislation will also clarify the rules for policies issued in respect of contracts made after midnight tonight. The general effect will be to bring the law back to where it was intended to be. The following provisions will apply:-

- i) post-1966 societies will now be allowed to amend their rules so that they can write tax-exempt endowment policies, as soon as the necessary rule amendment has been registered. This means that it will no longer be necessary for societies to use the **early** surrender of policies payable on death as a means of writing what are in effect endowment policies. The present requirement that life policies should be for the benefit of the widowed spouse or dependent child will be replaced by a simpler provision that life or endowment policies may be taken out by any adult member on his or her own life;

- ii) these societies will also be able to amend their rules so that they can do any class of taxable life assurance business which is permitted for friendly societies generally. Hitherto, for any of their business to be tax-exempt, their rules have had to limit the types of business they could do, whether taxable or tax-exempt (see para 5(iii) above). Following the curtailment in the Budget of the size of policies which they can issue on a tax-exempt basis, the restriction no longer has any point;

These two measures taken together amount to a significant relaxation of the present tight constraints on the life assurance business a post-1966 society is permitted to do under the Taxes Act 1970.

- iii) the upper limit on tax-exempt gross sum policies, set in the Budget at £750, will apply to the minimum sum assured as specified in the policy, and not to the expected maturity or surrender value. Sums assured under separate whole-life and endowment policies issued to the same member will have to be aggregated for this purpose;
- iv) the gross sum assured on tax-exempt policies must be not less than 75 per cent of the total premiums payable. This is at present an administrative

guideline, designed to prevent abuse of the limits, and will be given statutory effect. (This 75 per cent rule is already a statutory requirement for taxable policies issued by friendly societies and all policies issued by life offices, if the proceeds of the policy are not to be taxable in the hand of the recipient.)

11. Contracts issued by post-1966 societies assuring annuities payable on death to a member's widowed spouse or dependent children will continue to be tax-exempt. The limit of £156 per annum for tax-exempt annuity policies issued by any friendly society will apply to the minimum annual payment assured under the annuity contract, disregarding any enhancement due to investment-linking or bonuses. However, the surrender for a capital sum, for any reason, and at any time, of a friendly society annuity contract made after today will become a "chargeable event" for the purposes of the Taxes Act 1970. This means that any excess of the surrender value over the premiums paid will be subject to income tax in the hands of the policy-holder. This provision will bring annuities granted by friendly societies into line with annuities granted by life offices. The proposed change of treatment will not apply to surrender of annuities payable under contracts made before midnight tonight unless they have subsequently been enhanced.

12. Members who already hold a tax-exempt friendly society policy will only be able to take out a further tax-exempt policy, whether with the same society or another one, if it does not take the holder

over the respective limits for gross sum and annuity policies. For this purpose an annuity contract issued before midnight tonight, which is therefore not subject to the provision that its surrender for a capital sum would be a "chargeable event", will be treated as conferring an entitlement to a gross sum equal to 75 per cent of the total premiums payable under the policy, and this sum will count against the limit on tax-exempt gross sums assured.

### Implementation

13. The legislation necessary to validate existing policies will be enacted by a Friendly Societies Bill to be introduced as early as practicable in the next session of Parliament. Legislation amending the current tax provisions will be included in the 1985 Finance Bill. Draft clauses will be published as soon as possible to permit consultation with the appropriate representative bodies. The relevant provisions will be deemed to have effect from midnight tonight.

14. Until Royal Assent has been given to the 1985 Finance Bill, the Revenue will continue by extra-statutory concession to provide premium relief and tax repayments to the societies in respect of business to be validated by the proposed legislation.

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31 May 1984

Friendly Societies

Thank you for your letter of 30 May to Andrew Turnbull about the announcement which the Economic Secretary will be making today on the subject of insurance contracts made by Friendly Societies with their members.

The Prime Minister has noted the contents of your letter without comment. She was grateful to be kept informed.

(David Barclay)

A.M. Ellis, Esq.,  
H.M. Treasury.

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15 March 1984

A N Ridley  
Special Adviser

David Hunt Esq MP  
House of Commons  
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*Dear David,*

BACKGROUND BRIEFING ON BUDGET FOR BACKBENCHERS

Following our discussions earlier today, I am sending over to you now 15 copies of a brief for yourself and your colleagues in the Whips' Office. It deals with the background to four issues:

- the kinds of policies affected by the withdrawal of Life Assurance Pension Relief;
- the withdrawal of Life Assurance Relief and other changes in the tax status proposed for the Friendly Societies;
- the extension of VAT to take-away food;
- the extension of VAT to all but new construction activity.

2. These briefs have drawn on advice from officials in the Inland Revenue, the Registrar of Friendly Societies, and the Treasury. And they have been approved by the Chancellor and the Economic Secretary. The Chancellor agrees with your suggestion that at this stage it would not be sensible to make them generally available to colleagues on the back benches. But to guard against the need for this, I am also sending a copy of the material to Peter Cropper at the Conservative Research Department, so that he can run it off and get it to the office in a hurry should you find this to be necessary.

3. When we discussed this possibility this morning, we both agreed that there was a difficult choice to be made as regards the degree of detail in which one describes the impact of the changes following the extension of VAT. At the moment I have gone in the direction of giving full information, in order to answer all questions, and in particular have included most of the key features of the two important Customs & Excise pamphlets which have been made available in their VAT Offices to anybody who wishes to explore the implications of the changes now proposed. But it is clear that it could well be better in the event, should a brief need to be put in your office for backbenchers, not to include the photo copies of those two pamphlets. If that should be needed, very small amendments would be needed to the preceding text in the initial two sections on VAT.

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4. You will find that the legal complexities of the changes required to give effect to the changes proposed for the Friendly Societies are really rather complex. There is some recognition of this at the end of the brief, but I have - I am sure prudently - rather underplayed this. If, however, legalists should become upset or fascinated by the complicated procedures so required, we could no doubt ensure for fuller briefing for them in due course.

*Yours ever*

*Alan*

A N RIDLEY

P.S. I am also sending you alone one copy of the Treasury Press Release on the registered Friendly Societies, to which is attached an important letter from Ian Stewart which he sent them on Budget Day. For those who are less interested in the complexities and more interested in the politics, this could be helpful!



FRIENDLY SOCIETIES: WITHDRAWAL OF LIFE ASSURANCE PREMIUM RELIEF AND  
OTHER CHANGES

As the role and tax treatment of the Societies are not widely understood, it may be helpful to set out the background to the withdrawal of LAPR and other important changes proposed in their tax status.

LAPR

1. The Societies' original purpose was self-help, as with many other "mutual" organisations such as the Oddfellows, Burial Societies and so on, in the days when there was no welfare state. Until 1966 all their business was tax-exempt. Though their role is less important than it was, there are still many such bodies. Most are small, collecting modest sums from and paying modest benefits out to their members. So their activities are dwarfed by the conventional Life Assurance industry. A few have become very large however, such as the "Royal Liver"; and a fair number - both large and small - have over the years operated increasingly aggressively in marketing the services they have to offer.

2. Like the ordinary Life Assurance Company, they offer two convenient savings instruments in life insurance form: contracts for lump sums; and annuities. Typically these were "qualifying policies", like many other Life policies, and conferred eligibility for LAPR on the individual who took them out (if he had headroom within the Inland Revenue ceiling of 1/6th of income or £1,500, whichever was greater). The Budget has therefore proposed abolition of LAPR on new Friendly Society policies, as on all other qualifying policies. But other important changes are also to be made to the tax treatment of the Friendly Societies.

3. Friendly Societies are faced with one complication, which does not affect life assurance companies, in adapting to the abolition of LAPR for new policies. Societies' contracts with members are based on their rules, and in most cases a member's entitlement to deduct LAPR is set out in a 'scheme' originally prescribed in an order by the Chief Registrar, and then annexed by the particular society to those rules. So societies could have problems in writing new business on the new "gross" basis until the amendment of the Finance Bill legally removes the right to LAPR in respect of new contracts. The Chief Registrar has accordingly made an order under the Finance Act 1976 amending the 'scheme' so that it does not apply to new contracts.

## Change in Tax Status

4. Two forms of Friendly Society have evolved since 1966, operating under significantly different tax régimes.

5. The "Tax Exempt". Until now these societies operated with
- complete corporation tax (CT) exemption on their profits, in contrast to ordinary life assurance companies, who have received "franked" income already taxed at 30 per cent paid CT at the privileged but substantial "pegged rate" of 37½% on their income from other sources;
  - complete capital gains tax exemption, in contrast to the 30% rate paid by ordinary life offices;
  - no tax of any kind payable by the society or the policy holder when the benefits are distributed.

But all of this was subject to the rules of the society providing that the maximum sum assured on any life or endowment business was (latterly) £2,000; and the maximum annuity £416 per annum.

6. The "mixed business" Societies. These were, as their name suggests, transacting:
- both on a tax-exempt basis, with the same unusually liberal régime as their tax-exempt brethren, in which case they were able to do so provided their rules stipulated even tighter maxima of £500 for sums assured, and £104 p.a. for annuities;
  - and on a non-exempt basis, with much higher limits of £50,000 on sums assured, and £5,000 p.a. on annuities;
  - in their non-exempt business the societies' tax treatment was identical to that of any ordinary life insurance company, but naturally this division of the societies' activities into two distinct categories has required them to operate with notionally separate funds for each class of business!

7. As can be seen, the tax-exempt societies enjoyed a double advantage. First, they were able to market larger lum-sum untaxed undowment annuity policies than the mixed societies. Second, both classes of society were able to compete on privileged terms with ordinary life offices even if subject to the severely limited minima set out in their rules.

8. The tax-exempt societies in particular, including latterly some specially set up for the purpose, have been very aggressive in

marketing their policies, in a manner not consonant with their traditional philosophy. Clearly, if they do so, this is unfair both to the mixed-business society, with its lower limits, and the conventional life insurance company with its tougher tax régime.

9. In addition the Government's general desire to introduce more neutrality and even-handedness into the operations of financial institutions naturally raised the issue of whether there is now any justification for special tax-exemption for the societies.

10. The Government has concluded that these two special problems called for the following changes in the treatment of their new business:

- a) Since the societies' traditional social role is still valuable (e.g. in providing death benefits) they should be allowed to continue to write tax-exempt business, subject to modest limits in keeping with the nature of that business.
- b) These limits will be significantly above (half as much again) those followed up till now by "mixed business" societies, at  
£750 for maximum sum assured  
£156 for annuities.
- c) They will apply to all societies, both tax-exempt and mixed business.
- d) In addition as far as their conventional non-exempt business is concerned, mixed business societies will be permitted to operate under higher limits from May 1 1984, which will be  
£60,000 for sums assured (previously £50,000)  
£6,000 p.a. for annuities (previously £5,000 p.a.)

The £60,000 ceiling on sums assured will enable societies to issue insurance policies associated with house purchase loans up to the Building Societies' current special advances limit.

11. In sum the effect of these changes is to
- reduce the unfair competition by tax-exempt societies and the abuse of their special tax status;
  - enhance the traditional role of the mixed-business societies, for which continued tax-exemption up to modest levels is clearly justified; and to increase the opportunities open to them in their taxable business.

12. It should be noted that since these changes in tax status depend on the societies changing their rules. The constitutions of the Societies differ considerably; but in the traditional ones, consultation of the membership and a General Meeting may be required,

which can take some time. Thus the administrative and legal procedures required to give effect to these changes are inevitably more complex than most changes in tax law.

13. For further details of these measures. see the Treasury Press Notices "Registered Friendly Societies" and "Friendly Societies Tax Exempt Limits", to which is attached a letter sent by the Economic Secretary to the Chairman of the Friendly Societies Liaison Committee on March 13.